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# ACTUARIAL SOUNDNESS OF THE FEDERAL HOUSING ADMINISTRATION'S MUTUAL MORTGAGE INSURANCE FUND



## HEARING

BEFORE THE

SUBCOMMITTEE ON

HOUSING AND COMMUNITY DEVELOPMENT

OF THE

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

HOUSE OF REPRESENTATIVES

ONE HUNDRED THIRD CONGRESS

SECOND SESSION

JUNE 30, 1994

Printed for the use of the Committee on Banking, Finance and Urban Affairs

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# ACTUARIAL SOUNDNESS OF THE FEDERAL HOUSING ADMINISTRATION'S MUTUAL MORTGAGE INSURANCE FUND

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**THURSDAY, JUNE 30, 1994**

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON HOUSING
AND COMMUNITY DEVELOPMENT,
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS,
*Washington, DC.*

The subcommittee met, pursuant to notice, at 10 a.m., in room 2128, Rayburn House Office Building, Hon. Henry B. Gonzalez [chairman of the subcommittee] presiding.

Present: Chairman Gonzalez, Representatives Vento, Watt, Roukema, Baker, and Knollenberg.

Chairman GONZALEZ. The subcommittee will please come to order.

Well, the good news is that we are not likely to be interrupted by any votes on the House floor. The bad news is that most of the members have probably taken off, except I will announce that Mrs. Roukema, the ranking minority Member, is here, but is attending a Republican conference and will be here as soon as she finishes that.

This hearing was called because we are in the process of perfecting the legislation for full House consideration, and some of the issues we have reserved for the full House involved the question of FHA single-family mortgage insurance fund, and reflective of the two reports we have gotten from Price Waterhouse for the Department of HUD.

So for that reason we feel it is imperative that we have this hearing. Sort of a preliminary report or review, in my case, of a necessity, not in-depth. It is clear that the reports recognize substantial improvement in the solvency aspect of the single-family fund.

According to the report, as we said in the last markup, the fiscal year 1993 capital ratio reached 1.44, projected capital ratio is 3.40. So what we were talking about in the 1992 act was 1.25. And so the anticipated projection, which I think in today's world has to be tentative, is still very optimistic.

So I realize that the status of the fund is improving, but we are in the need of passing legislation that will increase the authority of the FHA as it applies to this particular program and its impact on the fund.

And I was hopeful that today's testimony will address the anticipated effect of those initiatives on the future solvency of the fund. On a different note, I hope that the testimony will address my concern as to whether the FHA has the capacity to administer the initiatives as proposed in the Housing Reauthorization bill.

The report on the financial statement recognizes four material weaknesses in the FHA. These weaknesses have been revealed in years past, and of course, I, for one, have known the magnitude of the problem, given the vicissitudes and—like we in the House, unpredictability, and the failure in the past years to come to grips, even though we had the inspector general's report telling us, and we were reporting.

That is over in the area where we in the Congress of a necessity and I personally do not want to mix. It has always been a clear line of demarcation in my mind, in my legislative career, between the clear policy or political functions and the administrative. Never have I ever interfered, whether it was on the local basis, State basis, national basis, in my 32½ years.

I am also aware of the budget constraints and both the inanity and the insanity of what has crept into the so-called budgetary process, which, as I have said and pointed out time after time, goes back to the 1974 both legislative as well as the Budgetary Reform Act.

The idea, even as late as 22 years ago, 21 years ago, that we would be actually progressing on the basis of month to month, almost, so-called appropriation committees—rather, resolutions, of a temporary nature. Then more insidiously, in the last Congress and a half or two, the so-called dire emergency supplemental.

That would have been unthought of by those old misters that the Reform Act was supposed to constrain from their arbitrary and authoritative nature. The fact is in the nature of reform we have entered what I consider to be, as in the case of the greater danger, which now is beginning to get some public attention, on the value of our currency, which has reached almost a point of being devaluated, as we have been saying for 20 years.

I just feel constrained to say that in this case also it is impossible to expect from the administrative branch a very efficient and stable type of administrative behavior if the budgetary nature is of such a kind that there is no way that a manager can predict what he will have in 3 months' time, for instance.

So I must point that out. That is with a great deal of sympathy with this administration and the one immediately preceding in HUD. I have a great deal of sympathy and empathy. This is something that is right flat square on the door steps of the Congress. And we have to face that.

I hope that the Congress receives a commitment that in the meanwhile, in spite of the budgetary restraints and the weaknesses in administrative functions, as pointed out by successive inspectors general, will be addressed.

[The prepared statement of Chairman Gonzalez can be found in the appendix.]

Mr. Vento.

Mr. VENTO. Thank you, Mr. Chairman. Thank you for convening the hearing, and especially Mr. Retsinas and the folks from Price Waterhouse.

These events in the past have forced us, in the last few years, to learn more and more about the working of the models and stress tests and a variety of other things that add up to looking at the FHA book of value for the MMI Fund and for other programs more than I guess we thought about. For a long time FHA was probably taken for granted as being a workable benchmark program to accommodate homeownership, one of the most successful programs ever to do so.

And today, happily, because the numbers are coming back, we perhaps don't look as much at the black box model that adds up to the numbers that we want to see at the bottom of the line. I think we need to explore to some extent the volatility of that, and I might note that in the executive summary of Price Waterhouse, which I have had a chance to look at, I am pleased to note that you do talk about the uncertainties and the variables that are not possible to measure, the lack of appraisals, and the assumptions that you make.

I think this is very helpful for us to realize, not just when we were doubtful about the results for a model, but also when we are utilizing them. Perhaps more importantly, we are utilizing them to—in fact, as the base for moving forward to resume the role of FHA. We need to look very closely at this.

The truth is, of course, that because of the nature of events, the last years, we were always waiting for the next report to come out in terms of giving us a signal, the other shoe to drop, so to speak. And I know, Mr. Chairman, in your materials that you provided the members of the subcommittee, that you are pointing out the GAO is now coming out with a report in September.

I am wondering when we are sitting in conference—hopefully, we will be all done by then, but human nature being what it is, we don't get things done without a deadline, and the deadline is October 1, and we are sitting in conference and out comes GAO with a report that casts a shadow over Price Waterhouse or the FHA. It is the nature of the legislative bodies, and the fact is that most of us are not experts on these topics.

Mo Udall used to say there are two types of people in Washington: Those that don't know and those that don't know they don't know. I think most of us are well-advised to recognize that we don't know all the answers. And I think it also serves as a guide to those that are working in the process with us, to recognize and assist in the way they best can to facilitate this process.

But I am pleased to see the administration, based on the progress and the change in numbers, willing to move forward aggressively. I think we need to know exactly, as we legislate, what it means to have a broader book of business, to eliminate and simplify the process.

And, Mr. Chairman, I want to say that all of us are pleased to see the numbers, the bottom line look better. I also feel some concern about the types of premiums that we have placed in the program and what that means to those constituents that are paying those premiums year in and year out in terms of their ability to own a home and to have affordable housing in this country.

We can keep the insurance, we can put in penalty payments, a variety of issues with FHA that make the fund look better, but the question of equity is one that obviously concerns us.

I think it is a good day, and hopefully, we will be, while not cynics, hopefully skeptical to some extent of the information that is brought to us. I think it helps greatly when the administration and those that are working in terms of developing the information, are free to share the limitations so that we know where the shortcomings are in that information.

But I am generally pleased. I am pleased that FHA has pursued the model of demonstration and is aggressively pursuing a broader role in the marketplace. And I hope that this report will continue to sustain that type of change in policy.

Thank you very much, Mr. Chairman.

Chairman GONZALEZ. Thank you, Mr. Vento.

This morning we want to express our gratitude to the Assistant Secretary, Mr. Retsinas, Mr. Chris Greer, and with him, Mr. Tom Craren, and Mr. Barry L. Dennis, and of course, Ms. Jacquelyn Williams-Bridgers, for responding to our invitation with notice.

So without any further ado, we will recognize you and proceed with the Secretary, and thank you once again for your help.

**STATEMENT OF NICOLAS P. RETSINAS, ASSISTANT SECRETARY FOR HOUSING, FEDERAL HOUSING ADMINISTRATION COMMISSIONER, U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT**

Mr. RETSINAS. Thank you, Mr. Chairman, Congressman Vento. It is indeed a pleasure to be here this morning.

If I could, Mr. Chairman, I will dispense with reading my prepared remarks and submit them for the record, and give you, if I could, an overview of my perception of the status and solvency of the fund and address some of the issues you raise.

Chairman GONZALEZ. If you yield to me, I will at this point announce that each one of the witnesses' written and prepared testimony will appear in the record as you gave them to us, and then you may proceed as you deem fit.

Mr. RETSINAS. Thank you again, Mr. Chairman.

Mr. Chairman, thank you for conducting and holding this hearing. This is the kind of hearing and the kind of information that often does not get the attention of those who need to have it brought to their attention. I am pleased that you have taken the time once again to listen to this information and, as Congressman Vento has indicated, to be skeptical and give us a chance to demonstrate the value, utility, and honesty of this information.

Second, I appreciate on both your behalfs the insights that both of you have. Certainly, both of you understand almost better than anyone the history, context, and status of the Federal Housing Administration and its purposes.

Mr. Chairman, having now been on the job for about a year, I particularly appreciate your acknowledgment of the constraints that we face, the constraints that are borne of past trends, past circumstances, but exist today and are indeed inhibiting. And I would hope some of the actions we have taken over the past year have begun to look forward rather than backward as it relates to the future of the fund.

My first opening comment is, this is an interesting and symbolic time to conduct this hearing. As you know, earlier this week, June

27 marked the 60th anniversary of the Federal Housing Administration. It began in 1934. Before there was a Federal Housing Administration, if you wanted to buy a home in these United States, you would have needed a downpayment of about 50 percent and you would have been lucky to get a 5-year interest-only note. With those kind of barriers, there was not widespread homeownership.

The Federal Housing Administration was a pioneer, showed that in fact it was possible to lend long term to hard-working American families, and as both of you have pointed out, the proof is in its record.

In its 60 years, over 21 million families have been assisted, many of whom are first-time home buyers. It has made a significant contribution, not just to those families but I think to the country. Thank you for your past support and the opportunity to give you an update on its status.

It was last July, and I had been on the job less than 2 months when I testified before this subcommittee on the status of the fund. As I reported on the reports for the fiscal year ending September 30, 1992, my comment in that testimony was that the Mutual Mortgage Insurance Fund remains solid and its financial condition is improving.

I am here to report to you again this morning that the fund remains solvent, and indeed its condition continues to improve. I then point out in my testimony some of the reasons for that improvement.

As background for the fund, it is important to note, because it is often confused, that there are a number of FHA insurance funds. The testimony this morning will focus on the Mutual Mortgage Insurance Fund, the largest of our insurance funds. It is that fund which provides basic single-family mortgage insurance and is a mutual insurance fund. In this regard, we pay back to the mortgagors their share of surplus premiums paid into the fund that are not required for expenses or losses or to build equity. There are other funds that are separate from the Mutual Mortgage Insurance Fund: The general insurance fund, cooperative insurance fund, and the special risk insurance fund.

Later on I will talk about some of our legislative initiatives which really relate to those funds and do not impact on the Mutual Mortgage Insurance Fund, which is the subject of our discussion and testimony this morning.

I think it is very easy to get confused when we talk about actuarial analysis and audits and other kinds of financial reports. So if I could, Mr. Chairman, and members of the subcommittee, review the difference between the audit and the actuarial analysis, I think it is important.

The audit is a statement of the financial condition of the fund at a point in time and a summary of its operations over a period in time. And in this particular case, our audit covered the period for the fiscal year ending September 30, 1993, and it examined the fund's condition as of September 30, 1993. That audit had been previously submitted to this subcommittee. The audit also includes a report on internal management controls.

The actuarial analysis has another function. The actuarial analysis is not only to take into account the historical operations and financial conditions of the fund, it is to project future revenues and expenses, and discounting those revenues and expenses to the present, to assess the fund's present economic value and its capital ratio; that is, the economic value of the fund divided by the insurance in force.

As you recall, it was this subcommittee and this Congress that authorized and required such an actuarial analysis in legislation which I believe passed in 1990. Congress mandated a 2 percent capital ratio in the year 2000. Because of that target, the actuarial review focuses not only on the current year's capital ratio but projects the fund's behavior through the year 2000.

Because it is a projection, it is, of course, sensitive to the assumptions used. All projections are sensitive to the assumptions used. The Congress in its wisdom required that this actuarial analysis be independently conducted, that is to say, not conducted by the staff of the Department but conducted by a third party. In this particular case Price Waterhouse conducted the study, and they will be reviewing the results of this study this morning.

The independent actuaries, Price Waterhouse in this case, use economic assumptions; it is my understanding, and Mr. Craren and his colleague will report further that they use the assumptions of DRI, a nationally recognized forecasting firm.

Again, there are a variety of assumptions about interest rates, about our economy, that are taken into account. They are a necessary part of any projection.

Because the DRI assumptions are viewed as an industry standard, Price Waterhouse used them in the 1992 actuarial review, which provides consistency and comparability from year to year.

In addition, the General Accounting Office, which you will hear from later, which recently developed their own MMI economic model, also uses the DRI economic assumptions.

With that as preface, let me give you a brief overview of the study findings. This analysis, as required by statute, did two things. It estimated the economic value of the Mutual Mortgage Insurance Fund, defined as the sum of existing capital plus the net present value of current books of business, and it determined the current capital ratio, defined as the economic value divided by the total insurance in force. And it projected this ratio to the year 2000.

The National Affordable Housing Act of 1990 mandated that the Mutual Mortgage Insurance Fund achieve a capital ratio of at least 1.25 percent by the end of fiscal year 1992, and at least 2.0 percent by the end of fiscal year 2000.

On June 6, less than 3 weeks ago, Price Waterhouse transmitted its fiscal year 1993 analysis to me. That analysis indicates a dramatic improvement in the capital ratio of the fund, from 0.43 percent at the end of fiscal year 1992, as I reported to you last year, to 1.44 percent at the end of fiscal year 1993.

In addition, according to their analysis, the fund is projected to reach a 3.40 percent capital ratio by the year 2000, which, as you can understand, significantly exceeds the 2 percent requirement mandated by the act.

According to the study, the current economic value of the fund is $4.554 billion. This represents an increase of $3.149 billion between the end of fiscal year 1992 and the end of fiscal year 1993.

According to the projections, by the end of fiscal year 2000, the economic value of the fund is projected to be $15.254 billion. Again, to repeat and reiterate my conclusion from last year, FHA's Mutual Mortgage Insurance Fund is sound, and by maintaining responsible management, which we pledge to do, it will continue to be sound.

When we analyze what accounts for this increase from fiscal year 1992 to fiscal year 1993, we have identified six reasons.

Number one, there has been a favorable interest rate environment. Over the course of the last year, the FHA achieved its second highest level of endorsements in its history.

Number two, there has been a positive economic environment which is related, of course, to the positive interest rate environment. And because of that, the number of claims paid declined due to more favorable economic conditions.

Three, we have made modifications in our management policies, modifications relating to our assignment program, to our lender monitoring, and to our claims procedures, all of which we think make a positive contribution to the fund.

Four, there have been changes in the past year with our refund policy. That refund policy and the calculation of that refund policy and its valuation is a component of the increase in the value of the fund.

Five, there has been an increase in the level of prepayments. Prepayments, specifically those repaying out of the fund, had the largest effect on the fund's improved status, increasing the estimated fiscal year 1993 economic value by $1.2 billion.

And last, the sixth reason is a positive economic forecast. Not only is the current economic environment positive, but according to the projections used by Price Waterhouse, there is a positive economic forecast which also impacts positively on the fund.

We know, as you pointed out in your opening remarks, Mr. Chairman, that our work is not over, and this is no time to rest on what has been an increase in the solvency and value of the fund. If anything, it is a time to reinvigorate our efforts to ensure the sound management of the fund.

Our agenda includes the continued aggressive monitoring of our portfolio and the mortgagees who participate in the Direct Endorsement Program, more effective default monitoring mechanisms and improvements in the management of the portfolios, increased use of technological enhancements to make sure that we are as efficient as we possibly can be in the managing of that portfolio, and a variety of other administrative and program improvements that we believe make the program user-friendly and more susceptible to positive use by our mortgagees.

There are several legislative initiatives which impact on the mortgage insurance funds. Most of the initiatives relate to the general insurance fund. There are a couple, however, that relate to the Mutual Mortgage Insurance Fund.

One is an increase in loan limits for both the floor and the ceiling. And let me thank, if I could, the subcommittee for the action to date in honestly considering those recommendations.

We believe that the increase in loan limits will have a positive effect on the fund. FHA experience indicates that historically the higher value loans have a lower claims rate than the lower balance loans. We believe that this will allow us to continue to increase the solvency of the fund, and perhaps, more significantly, to use the added value to allow us to reach out and spread the use of the program to those most in need.

In addition, we have proposed authority for streamlined refinancing of certain assigned mortgages as well as for nonjudicial foreclosure procedures. We believe in both cases they can add significant value to the fund by saving us money.

In addition to legislative changes that have a direct impact on the fund, we believe there are a number of other technical changes that can have a positive impact. For example, in considering our legislative initiatives, we recommended that under certain conditions, for certain lenders, with appropriate recourse, we expand our direct endorsement processing to allow lenders to issue the mortgage insurance certificates. We believe that that will minimize the backlog that now exists because of the staffing and resource constraints the Department faces.

We have also considered a simplification of the calculation of the maximum insurable mortgage amounts. Right now, parts of our calculations are just too complex, and we would hope you would give us the authority to simplify those calculations.

In addition, we believe the expansion of the Home Equity Conversion Mortgage Program could be of significant value to elderly homeowners.

The FHA has served as the cornerstone of America's housing market for over 60 years. There have been setbacks, such as the financial challenges of the 1980's, and that indeed is a valuable lesson to us all.

Today, I am pleased to report that FHA's Basic Single-family Program is financially sound and is projected to continue to be sound. With this as a base, we can turn our attention and refocus our energies to making sure we can address the needs of home buyers, to make sure that we maximize and increase homeownership, particularly among hard-working American families.

I see FHA's greatest potential being its ability to leverage other capital for public purposes, primarily through partnerships. With this in mind, I have been asked by Secretary Cisneros to conduct a study of the appropriate structure of the Federal Housing Administration, and ask the question whether today's structure, in light of the constraints that you pointed out, Mr. Chairman, is the appropriate structure to deal with the issues, the problems, and the opportunities facing this country.

This study will include a series of six forums around the country to discuss the future of FHA. These forums will bring together HUD and its employees, with residents, housing advocates, housing providers, builders, realtors, mortgage bankers, the secondary market, as well as State and local governments, to talk about our organizational structure and how it either helps or hinders partnerships.

These forums will begin this summer and will conclude at the end of this calendar year. I believe that these discussions have the promise of helping us remove the bureaucratic barriers that limit the effectiveness of FHA.

Ultimately, we want to transform FHA to a vehicle that can meet America's housing needs in the 1990's and beyond, while ensuring that the MMI Fund remains adequately capitalized.

Our goal is to ensure that when the transformation is complete, FHA will be a first-class institution, with the same tools used by the best-managed businesses and other comparable organizations. FHA will then be in a position to fulfill its mission, to expand housing choice and support communities by helping create partnerships that develop and preserve affordable housing.

FHA will once again become a positive force for increasing homeownership and affordable housing opportunities for all Americans.

I believe the actuarial review we are reporting on this morning gives us the foundation to embark upon this exercise, which is too important to be put aside.

Mr. Chairman, that concludes my remarks. I am, of course, available to answer any questions that you or other members of the subcommittee may have.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Retsinas can be found in the appendix.]

Chairman GONZALEZ. Thank you.

Mr. Greer.

## STATEMENT OF CHRIS GREER, ASSISTANT INSPECTOR GENERAL FOR AUDIT, U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

Mr. GREER. Good morning, Mr. Chairman, members of the subcommittee. We are pleased to be here this morning to discuss the financial condition of the Federal Housing Administration [FHA], and more specifically its Single-family Programs.

Our office issued the most recent financial statement audit of FHA on June 8, 1994. The audit covered FHA activities during fiscal year 1993.

Accompanying me today is Tom Craren, a partner in the certified public accounting firm of Price Waterhouse. Tom has been personally involved in the financial audits of FHA since 1988.

The three most recent FHA audits were conducted under contract with our office, the Office of Inspector General, and in accordance with the Chief Financial Officers Act of 1990. Our staff works very closely with Tom and his staff in monitoring the completion of the audit and in providing input based on OIG audits of FHA Programs and related issues.

Tom has prepared a written statement concerning his work and will share that with you in a few moments. I would like to point out a few things that were contained in our most recent semiannual report to the Congress.

In that report, we assess HUD's progress in addressing its 10 most significant problem areas. We have been reporting on these problem areas to Congress since 1992. Three of these areas are systemic in nature and affect almost everything that HUD does.

These systemic issues include HUD's management control environment, resource management, and data systems. These weaknesses have a direct impact on seven programmatic areas, one of which is the single-family housing asset management.

In chapter 1 of our semiannual report, we point out that controls over HUD's multi-billion-dollar single-family note servicing and property management are inadequate, and we comment on Nic Retsinas' plans and actions to correct the problems.

In short, we conclude that while there has been extensive analysis and strategic planning devoted to solving the problems, it is really too soon to tell if the planned activities will in fact materialize and make a significant difference.

Key efforts include changing staffing patterns and skills, finding alternative methods such as mortgage sales to reduce workloads, and modifying or reengineering current processes such as assignments and property disposition.

We believe that if the Office of Housing sustains its current momentum and focus, many of the past management practices will in fact be alleviated over time.

The other point I wanted to make is that our semiannual report contains some information about the HUD–OIG's Office of Investigation. They continue to encounter significant numbers of criminal matters associated with single-family programs.

During the 6-month period ended March 31, 1994, 49 cases were opened involving single-family fraud, Actual results from prior cases include 54 persons indicted and 59 persons convicted. Cash recoveries amounted to about $3.5 million.

Our Office of Investigation is currently pursuing either alone or in cooperation with the FBI or other Federal inspectors general, about 317 potential criminal cases involving single-family programs.

For the most part, we find that the criminal cases tend to be isolated instances of malfeasance by mortgage personnel or brokers in the origination of loans and by speculators or investors in strawbuying schemes.

Mr. Chairman, my statement is very brief this morning because I think you really want to hear from Mr. Craren and Mr. Dennis about the FHA audit and the actuarial study.

Thank you, and I will be happy to answer any questions you might have.

[The prepared statement of Mr. Chris Greer can be found in the appendix.]

Chairman GONZALEZ. Thank you very much.

Mr. Craren.

## STATEMENT OF THOMAS J. CRAREN, CPA, PARTNER, PRICE WATERHOUSE; ACCOMPANIED BY BARRY L. DENNIS, PRINCIPAL, PRICE WATERHOUSE

Mr. CRAREN. Thank you, Mr. Chairman.

It is easier to abbreviate my statement because a lot of it has been covered by Mr. Retsinas and Mr. Greer. We are pleased to be here today.

This is the second time you have held hearings, which we think are an important part of both the audit, the financial audit process, and the actuarial review. As was mentioned, the audit was performed under the CFO Act and it covers all the FHA's major activities, including its big Multi-family Programs.

It is important, I think, to state that you can't speak about HUD's programs individually. Although they are financed by separate pots of money, they are managed by one group of people. To the extent there are constraints on staff resources or workloads in multifamily, it can affect the single-family area.

The MMI actuarial study is done under National Affordable Housing Act, and as Chris mentioned, Barry Dennis who is with me today, headed that study, and will also help answer any questions you might have, Mr. Chairman.

The financial statement audit and the actuarial report present a number of relevant pieces of information about FHA's financial information, its soundness, and its internal control structure. For example, the financial statements will present FHA's net equity or deficiency position in accordance with generally accepted accounting principles, which is analogous to a private company's net worth. With respect to the actuarial study, the MMI Fund's economic value is presented as well. This is somewhat analogous to equity determined on a mark-to-market or fair-value basis, which many private financial institutions are beginning to present. Both are distinct and relevant measures about the MMI Fund's financial condition. And I think when you are considering the status of the fund, you have to look at both. You can't look at one individually at the exclusion of the other.

I think the purpose of our actuarial study, turning to that, is well known. We are charged to independently calculate the MMI Fund's economic value and the capital ratio. And to reiterate, the current and projected capital ratio is a measure of the extent to which the MMI Fund has or will develop resources in excess of what is required to cover any expected future claims.

As Mr. Vento pointed out, insurance is a risky business, and economic factors can fluctuate. That is why we have capital standards for the MMI Fund. Capital was meant to be a cushion against the uncertainty inherent in this type of business.

As a result of this year's review, we estimated the FHA Fund had an economic value of $4.5 billion, and when divided by unamortized insurance in force of $316 billion, it leaves you with a capital ratio of 1.44 percent, which exceeds the 1.25 percent that was required in 1992.

We also project that the fund will exceed the fiscal year 2000 target of 2 percent, but again, as mentioned ealier, there is a great deal of uncertainty about this projection. We don't know what the economy is going to do over the next 7 or 8 years, but we have relied, as Mr. Retsinas pointed out, on the economic forecast by DRI/McGraw Hill.

The current position of the fund is a $3.2 billion improvement over 1992. We think this has, for the most part, resulted from improved economics, lower interest rates, as Mr. Retsinas pointed out, and we think changes the FHA premium refund policy also contributed roughly $474 million.

In our testimony we have some graphics which highlight the dynamic impact of accelerating prepayment rates, which we simply couldn't predict last year—no one else could either—but which had quite a favorable impact on the fund.

The economic value of the fund and its pattern of capital accumulation to fiscal year 2000 depends on several factors, like the Nation's future economy during the lifetime of FHA's books of business. Interest rates affect initial and ongoing payment burdens on household cash-flows, and hence default risks. Interest rates also affect the potential for prepayments due to refinancing, as prevailing interest rates change during the lifetime of each book.

Faster average house price growth facilitates the growth of home equity, which tends to reduce the likelihood of borrower default. It also contributes to greater mobility and household asset portfolio rebalancing, leading to a greater turnover of housing and refinancings, thus increasing prepayment rates. Faster income growth reduces the burden of mortgage payments on household cash-flows over time, reducing the risk of default and claims as mortgages mature.

The base case results in this report are based on DRI's baseline forecasts as of May 1994 for interest rates, constant house quality prices, and inflation rates. We did some sensitivity testing, and we considered the DRI's pessimistic forecast, which projects lower real GDP growth and higher interest rates. We refer to this in our written statement as the high inflation scenario.

We also considered DRI's optimistic forecast, which projects lower inflation and interest rates, referred to in our written statement as the low inflation scenario.

The results are presented in exhibit 3 of our statement. As you can see, while the estimated economic value and the capital ratios do vary with macroeconomic scenarios, they change only moderately. In each case, the estimated capital ratio at the end of fiscal year 1993 exceeds 1.25 percent and the projected capital ratio at the end of fiscal year 2000 exceeds the mandated 2 percent.

We also did some tests on adverse selection. Adverse selection occurs when the conditions of insurance result in underwriting of higher risk loans while lower risks loans select lower premiums elsewhere. Because of the dramatic interest rate decline in fiscal years 1992 and 1993, FHA experienced an unusual number of prepayments, many of which left the fund.

The MMI premium structures are generally more competitive with private mortgage insurers for higher LTV loans and less competitive at the lower LTV level, providing a strong incentive for adverse selection. However, sufficient information is not yet available to either prove or disprove the existence of adverse selection with regard to the 1992 and 1993 prepayments.

We have examined the sensitivity of the 1993 actuarial results to two potential effects of the large prepayments. First, we assess the possibility that the unusually large prepayments left a higher mix of riskier loans in the existing books of business.

Second, we assessed the possibility that the large refinancings experienced in 1992 and 1993 substantially lowered the risk profile of the refinanced loans.

The lower risk profile is likely since refinancing lowers the monthly payment burden, while leaving other characteristics unaffected. In assessing the sensitivity of the results of the 1993 actuarial review to these effects, we have adjusted the projected conditional claim rates by selected amounts. We have little factual basis on which to select the magnitude of the adjustments. While we have selected adjustments we believe to be plausible, they are meant to be primarily illustrative.

The results of our analysis show that under all but the most extreme scenarios, the effect on economic value and capital ratio is moderate. Under all scenarios, we project the fund will still comfortably exceed the fiscal year 2000 NAHA-mandated capital ratio requirement. In the extreme negative scenarios, the fund would reach the 1.25 percent capital ratio, but later, in 1995 or 1996.

Now, let me turn to the financial statement audit, Mr. Chairman, which again covered both the single and multifamily areas. And the most significant observation from that audit is the fact that we were able to express an opinion on all of FHA's statements for the first time. Prior to that, we had to disclaim, because of problems with the data and the reliability of the financial information.

The prior problems we had were complicated by a weak internal control structure and a staff increasingly burdened by a growing number of problem loans and assets. FHA has continued to address these problems, and especially in considering how far it had to go 4 or 5 years ago, it has made credible progress.

We were particularly pleased that FHA was able to quantify multifamily credit risk, link the risk assessments to its asset management strategy, and calculate a loss reserve for the financial statements.

We also believe FHA's action plan to address remaining problems is a comprehensive and serious effort which merits support and aggressive followthrough. To reiterate a point Mr. Greer made, however, we are concerned about the followthrough. I think the plan is good, but FHA has not had a good track record of implementing its action plans.

Having said all this, a couple of cautionary notes are in order. First, a large portion of the expected improvement to the MMI Fund's capital ratio depends on the ultimate performance of insurance written in 1992 and 1993. Even though the current economic environment is quite favorable, the performance of these books of business will become more certain only as actual default experience emerges.

The financial statements, as opposed to the actuarial review, will not reflect the positive performance of these books for some time, even though their economic value is projected to be strongly positive.

Second, FHA's internal control problems are not solved and will still require attention. A tight budgetary environment doesn't make it very easy for FHA to invest resources in people and automated systems to help correct these problems. We have always found this phenomenom unusual for FHA, because despite having very good cost-benefit justification for making an investment in watching its loans more closely, it has been unable to make such an investment.

By any measure, FHA is a huge financial institution that often enters into complex credit transactions involving many different types of loans. Because there is so much at stake particularly with respect to a large, complex loan, private financial institutions typically pay a lot more attention to them than FHA does. This is done by frequently monitoring the underlying financial strengths and weaknesses of the loans and the condition of the property securing them. Private institutions are especially careful to closely watch those loans that begin to show problems.

The reason it is so important to identify a loan weakness as soon as it begins to manifest itself is that experience has shown if loan problems go unattended or underattended, solutions become much more difficult and often more costly.

Potential losses that are quickly identified and addressed are those most likely to be prevented. There is clearly a cost-benefit tradeoff between resources dedicated to the credit management process and portfolio performance.

For a large and complex credit operation like FHA, this normally implies a fair degree of resource investment in terms of the experience and number of people involved in the credit process, the means to train them, and modern tools for them to use.

We have a chart in our written testimony which illustrates our concern with respect to the multifamily area, an area where FHA is quite squeezed in staffing. Certainly, its staff numbers do not compare favorably to either private institutions or State finance agencies.

Another area that has been mentioned is early warning and loss prevention. And one of the ways of addressing FHA's workload problem and improve FHA's financial condition is to institute a comprehensive, flexible program to identify potentially troublesome loans quickly enough to allow for effective corrective measures. This has the effect of curtailing foreclosures and reducing the number of loans that potentially would be assigned to FHA, thus freeing up people to do other needed tasks.

FHA has recently dedicated much effort to identifying problem loans in its insured multifamily portfolio. This is a significant achievement because these are the loans for which preventive measures may yield immediate benefits in terms of potentially avoiding large claim payments. But this process is still very staff intensive and often entails cumbersome manual data gathering in order to develop a basis for making a proper decision.

Lack of a complete and accurate data base regarding the performance of insured multifamily loans and the lack of a system to assess and summarize this data continues to slow FHA's progress.

The single-family areas experience some of the same problems but to a much lesser degree. Unlike multifamily, single family has a quality control mechanism, its mortgagee monitoring division, which has been able to expand and enhance its activities. Even though improvements have been made, we still believe it is necessary for FHA to develop more flexibility in its single-family loss-prevention efforts. For example, a program that would make it easier to modify delinquent loans that have a good chance of having positive results, including reducing foreclosures and providing a less costly alternative to the Assignment Program. We understand FHA is currently in the process of addressing delinquent loans.

Finally, on the issue of Secretary-held mortgages, Mr. Chairman, these are the mortgages that have been assigned to FHA when a claim was paid in both the multifamily and single-family areas. For the last 4 or 5 years, they have been increasing rather dramatically, and virtually all of them were assigned to FHA as a result of defaults or other problems with the loans.

We have recently become more concerned about this issue. Given FHA's budgetary constraints, they need to dedicate more resources to asset management because the doubling of the portfolio may weaken FHA's overall control structure.

And again, we have a graphic in our written statement which shows the really dramatic growth in these notes over the last 5 years. FHA does have a strategy to address this issue, including selling loans, especially those under the 221(g)(4) Program, setting goals for returning nonperforming mortgages to a current status and streamlining the FHA's loan servicing efforts.

I think in the future one of the things I would recommend for the subcommittee is to have the audits monitor how well they are actually doing with this strategy to see if it is effective, and perhaps suggest other alternatives if it is not.

Another way FHA could become more efficient and improve its staff utilization would be to quickly implement and upgrade its automated systems. While efforts have been made in the past, especially with respect to improving property management systems, a greater push to upgrade other critical systems might yield additional benefits through, for example, more comprehensive and timely information about loan performance.

We strongly encourage any support that would expedite implementation of new systems and improve the quality of FHA's financial information and its ability to provide service to its customers.

Mr. Chairman, we believe FHA is making progress to shore up its financial condition and address in a serious and constructive way the problems and challenges we and other auditors have reported for a long time. But for this progress to continue, it is important that it continue to receive the attention of senior HUD management and the subcommittee.

To the extent legislative and budgetary support can accelerate FHA's improvement and ultimately save money, it should be strongly encouraged.

This concludes my statement. We would be happy to answer any questions.

[The prepared statement of Mr. Craren can be found in the appendix.]

Chairman GONZALEZ. Thank you.

Mr. Dennis.

Mr. DENNIS. My comments were included in Mr. Craren's statement.

Chairman GONZALEZ. I see. You have no prepared statement.

Ms. Bridgers.

## STATEMENT OF JACQUELYN L. WILLIAMS-BRIDGERS, ASSOCIATE DIRECTOR FOR HOUSING AND COMMUNITY DEVELOPMENT ISSUES, U.S. GENERAL ACCOUNTING OFFICE

Ms. WILLIAMS-BRIDGERS. Mr. Chairman, members of the subcommittee, thank you for the opportunity to present the results of our assessment of the actuarial soundness of the Mutual Mortgage

Insurance Fund. We hope that our testimony today will allow for the more timely consideration of our review results during the course of your reauthorization discussions.

My testimony will focus on our estimate of the economic net worth of the fund as of the end of fiscal year 1993, our assessment of the progress made by the fund in achieving the legislative capital ratios, and a comparison of our estimate with the estimate prepared for FHA by Price Waterhouse.

In summary, although there is uncertainty associated with any forecast, the economic value of FHA's fund clearly has improved significantly in recent years, and the fund is on its way to accumulating sufficient capital reserves to be considered actuarially sound under the law.

We estimate that the fund had an economic net worth of about $4.9 billion at the end of fiscal year 1993, compared to an economic net worth of a negative $2.7 billion in 1990.

We estimate that the economic net worth of the fund increased by about $4.3 billion during fiscal year 1993. We attribute this financial improvement to several legislative and programmatic reforms, but this improvement can be more significantly attributed to favorable economic factors that worked in conjunction with the legislative reforms to not only increase the estimated economic net worth of loans endorsed by FHA in fiscal year 1992 and earlier, but also to result in a positive contribution to economic value made by loans endorsed by FHA in fiscal year 1993.

Of the $4.3 billion increase in economic value during fiscal year 1993, we estimate that about $2.8 billion is due to the improvement in the loans endorsed by FHA in fiscal year 1992 and earlier. This increase was due primarily to more favorable house price appreciation rates, lower unemployment rates, lower than forecasted loan foreclosures and prepayments for fiscal year 1994 and beyond, and reduced premium refunds for borrowers prepaying their mortgages.

In addition to the $2.8 billion contribution, another $1.5 billion in value was added by the fund by fiscal year 1993 loans. Fiscal year 1993 activity represents the second consecutive year in which the fund's new loans made a substantial contribution to the fund's economic value.

The positive considerations of loans endorsed by FHA in 1993 is also indicative of changes made by both Congress and HUD. For example, as of July 1991, FHA borrowers were subject to the legislatively mandated higher premium payments.

We estimate that if FHA borrowers in fiscal year 1993 did not have to pay the higher premiums, the economic value of the fund at the end of fiscal year 1993 would have been about $4.1 billion, or about 16 percent less than our estimate of $4.9 billion.

Similarly, we estimate if FHA had not revised its premium refund schedule, the economic net worth of the fund at the end of fiscal year 1993 would have been about $4.3 billion, or 10 percent less than the $4.9 billion estimate.

While the fund has made substantial financial improvement recently, we estimate it fell short, about $3 billion short, of achieving the legislative mandate for capital reserves of 1.25 percent of its amortized insurance in force by the November 1992 deadline. However, it exceeded this ratio by the end of fiscal year 1993.

Whether the fund can sustain this progress and attain the legislative 2 percent target for reserves in the year 2000, and thereby achieve actuarial soundness under the law, will depend on many economic and program factors that will affect the financial health of the fund this year and over the next 6 years.

We did not attempt to project the economic net worth and capital ratio of the fund to the year 2000, because these factors are likely to change. Our estimates of the fund's capital reserves are particularly sensitive to economic factors, such as house price appreciation rates, which have a significant influence on the net worth of the fund and its capital ratio. Under economic scenarios where you have generally favorable economic conditions but lower rates of house price appreciation, FHA's fund would likely experience higher claims, and as a result, the economic value would decline.

Similarly, we estimate that had FHA reduced borrowers' up-front premium payments from 3 percent to 2.25 percent for fiscal year 1993 rather than in April of this year, and assume that the demand for FHA mortgages remains unchanged, the economic value of the fund would have declined by about $460 million or 9 percent from our economic net worth estimate of $4.9 billion.

A decline in home buyers' demand for FHA-insured loans could also adversely effect the economic value of the fund and attainment of the year 2000 capital ratio. Home buyers' demand for FHA insured loans depends in part on alternatives available to them. For example, higher loan-to-value ratios result in reducing the cash needed by borrowers to purchase a home.

Some private mortgage insurers, as you may well be aware, recently announced a plan to offer mortgage insurance coverage on conventional 97 percent loan-to-value ratio mortgages, which brings their terms closer to FHA's 97.75 percent loan-to-value ratio on loans for properties exceeding $50,000 in appraised value.

While potential home buyers must consider many other factors when refinancing their mortgages, such as the fact that FHA will finance the up-front premium as part of the mortgage loan, this action by private mortgage insurers could reduce the demand for FHA insured mortgage loans.

In a report earlier this month, as Mr. Craren of Price Waterhouse has just mentioned, they estimated the MMI Fund had an economic net worth of about $4.6 billion and a resulting capital ratio of 1.44 percent of the unamortized insurance in force as of the end of fiscal year 1993. This compares to our estimate of $4.9 billion net worth and a capital ratio of 1.83 percent at the same point in time.

Price Waterhouse also projects the fund will exceed its year 2000 capital ratio target of 2 percent with a 3.4 percent capital ratio. While there are some differences in the economic modeling techniques used and the assumptions made, our $4.9 billion estimate of the economic value of the fund exceeds the $4.6 billion estimate of Price Waterhouse by only about 6 percent or $300 million.

In view of the uncertainty associated with any forecast of the performance of the fund's loans over the life of 30 years, these estimates should be considered roughly equivalent.

In general, our model and Price Waterhouse's model use similar statistical techniques and both rely on many of the same key factors, such as rates of appreciation in house prices and changes in mortgage interest rates. We both view these as important determinants of mortgage terminations and economic value of the fund.

Our estimates of the fund's economic value are similar. GAO's estimate of capital ratio is higher than Price Waterhouse's estimate. Some of the difference results from the slightly higher economic net worth that we estimated. However, the primary reason for the difference is the fact that we used a lower end of fiscal year 1993 insurance in force amount than did Price Waterhouse to calculate our capital ratios.

We calculated the capital ratio on the basis of amortized insurance in force and not unamortized insurance in force, as did Price Waterhouse. We used amortized insurance in force because FHA insured mortgages are in fact fully amortized over the 30-year life of the loans. Price Waterhouse used unamortized insurance in force for its calculations so as to be consistent with its prior years' reports and because the data on unamortized insurance in force are considered more reliable than the data on amortized insurance in force.

If we had used unamortized insurance in force in calculating the capital ratio, our estimate of the capital ratio would have been 1.55 percent rather than 1.83 percent, even closer to Price Waterhouse's estimate of 1.44.

In summary, FHA's fund has made significant progress during fiscal year 1993 toward achieving the capital reserves needed for actuarial soundness as defined by the law. Clearly, the legislative and other program changes have helped to restore the fund's financial health and reverse the trend of the late 1980's and the early 1990's toward insolvency.

However, it should be recognized that fiscal year 1993 was an unusually good year for FHA, because actual economic conditions and forecasts of future economic conditions were favorable.

Nevertheless, forecasting economic net worth and resulting capital ratios to determine whether FHA will have the funds it needs to cover its losses over the 30-year life of the loans it has insured is uncertain. Loan performance and therefore the economic net worth and capital ratios will depend on a number of other economic factors, particularly on the rate of appreciation of house prices and program policies such as premiums charged FHA borrowers that prevail available over that period.

Loan performance will also be affected by the demand for FHA-insured loans, a demand that depends in part on the alternatives available from private mortgage insurers. It is important to carefully balance the desires to assist home buyers against the government's potential financial risk and the liability and its expectations of the housing market's future performance.

This concludes my statement, Mr. Chairman. I would be happy to respond to any questions that you or members of the subcommittee might ask.

I also ask, Mr. Chairman, permission to be joined at the table by Mr. Robert Procaccini and Mr. Jay Cherlow, who are the principal managers for our single-family financing work and the architects of our model.

[The prepared statement of Ms. Williams-Bridgers can be found in the appendix.]

Chairman GONZALEZ. Absolutely. I am also going to ask unanimous consent that all members of the subcommittee be permitted to submit witnesses questions in writing, both those here and those absent, provided they do so in an expeditious manner; that is, by the time they receive transcripts of the proceedings.

[The questions referred to can be found in the appendix.]

Mr. Retsinas, I wonder if you can explain the Single-family Risk-sharing Program as proposed by the Department and as amended by the committee in its markup in the full committee. I am sure you are familiar with that because you were present. And how that program may impact the solvency of the fund, in your opinion.

Mr. RETSINAS. The risk-sharing approach proposed by the administration will enable us to enter into partnerships with other organizations that are also trying to promote and increase homeownership in this country.

The specifics of the approach will vary, of course, depending on the partners. In fact, there were two proposals by HUD which would have authorized risk sharing. The risk-sharing initiatives initially are not proposed to be obligations of the Mutual Mortgage Insurance Fund. So in the short term they would have no negative impact or positive impact on the fund. Under the single-family risk-sharing proposal which is contained in H.R. 3838, we propose that we be allowed to enter into risk-sharing arrangements with State and housing finance agencies.

Mr. Chairman, as you know, in 1993 the Congress authorized, in 1992, the Department to engage into risk-sharing in Multi-family Mortgage Programs. Earlier this year, Secretary Cisneros announced that we had reached an agreement with 33 State and local agencies. As I recall, it was 27 States and 6 local agencies.

Given the track record of those agencies, we are confident that risk sharing would be a more prudent use of the government's mortgage insurance or credit enhancement authority than is currently the case. We believe there is a potential for parallel partnerships, although of a different sort, with State agencies for single-family housing.

We need to find a way, we believe, on a shared-risk basis, to enter underserved markets and serve the people we need to serve.

As I understand the amendment that the subcommittee considered, it would restrict the nature of the risk-sharing agreements by setting a ceiling of 35 percent on the amount of risk that could be shared by HUD and State agencies.

It is my understanding in consultation with several State housing agencies that this amendment, if adopted and enacted by this Chamber and by the Congress as a whole, would effectively preclude any risk-sharing agreements; that is to say, that the State housing agencies have indicated to me that the proposal adopted by this subcommittee would not leave any room for partnership.

So, therefore, while in theory we would have the opportunity for risk-sharing, at least according to those agencies affected, there would appear to be no pragmatic opportunity for such risk-sharing.

Chairman GONZALEZ. Very good. Thank you very much.

Now, also at this time, as you well know, there are provisions in the reauthorization raising the loan limit to $172,675, and the floor to over $100,000. These proposals, if passed, would greatly expand FHA's presence in the mortgage market, while at the same time substantially increasing the revenue to the fund.

What is the Department's justification for requesting these increases and analyses as to how these provisions may impact the stability of the fund?

I know you expressed concern about it, I think on page 5 of your testimony, "While financial soundness is a major FHA goal, I am deeply concerned that the Single-family Program has suffered serious market decline over the past decade. I am particularly alarmed at a recent General Accounting Office report which shows that the percentage of FHA borrowers to all home buyers declined from a high of 30.7 percent in 1976 to only 23.8 percent in 1991. The study also shows that FHA's percentage of originations in urban neighborhoods declined from a high of 58 percent in 1979 to 41 percent in fiscal year 1991."

So my question is, the expected impact, if any, to the stability of the fund.

Mr. RETSINAS. Let me answer that in several ways, Mr. Chairman. Let me, first of all, thank the subcommittee for its consideration to date of those initiatives. I think they will increase the solvency of the fund, expand opportunities for home ownership in certain parts of this country, and more importantly, give us additional opportunities to use the fund and its programs to reach out to those most in need.

And let me elaborate on each of those three points, if I may. One, I believe that raising the ceiling to a realistic and an indexed figure is appropriate given the fact that there are currently certain housing markets in which housing prices are outside the reach of moderate-income home buyers, and the special value of the FHA Mortgage Insurance Program, which is its low downpayment, its flexibility in certain requirements, is not now available. So we think in isolated cases, in certain markets around the country, it will open up more doors to homeownership.

As it relates to the matter of increasing the floor, again, in selected areas, in more diverse parts of the country, including not only urban areas but rural areas, the simple fact of the matter is the cost of constructing a new home can exceed the floor that is now in the FHA Mortgage Insurance Program.

As I recall, Mr. Chairman—and I defer, of course, to your knowledge of this—the last time the floor was changed was 1980. A lot has happened in 14 years to housing prices and cost of housing in this country. And it seems it is appropriate to consider an index that can correlate with housing prices.

Second, we believe that such increases will not only simplify the program, particularly raising the floor, but we think also such actions will increase the solvency of the fund. As I pointed out in my oral testimony, FHA experience indicates that historically, larger loans have more of a positive return to the fund than the lower loans. Larger loans perform better than the lower value loans.

And third, because the fund will be on a sounder financial footing, the capacity of FHA to reach out to nontraditional and underserved buyers will be enhanced. The fund's better business can cross-subsidize its more risky business.

So we think increasing service in certain markets, amplifying the program, and increasing the solvency of the fund are all potential benefits of this initiative.

Chairman GONZALEZ. I really appreciate that, and I will have related questions to another witness, but it has been proposed that FHA loans be limited to first-time home buyers. What are your views on such a proposal, and what impact would it have on the fund?

Mr. RETSINAS. I certainly don't at all quarrel with the intent of a focus for the program on first-time home buyers. As a matter of fact, as I recall the data, exclusive of refinancing, approximately two-thirds of all originations for FHA mortgage insurance were for first-time home buyers. So it already is a significant benefit to first-time home buyers.

The difficulty, Mr. Chairman, in restricting the use of the program is that any restriction runs counter to the notion of an insurance fund that is diverse and solvent. It seems to me that if we are to continue to insist, and appropriately so, that the fund be self-sustaining, that it not require government subsidies or appropriations, we need to give it that opportunity to be so by serving a range of home buyers.

Therefore, I would question any restructuring in terms of its impact on the continued solvency and ability of the fund to be self-sustaining.

Chairman GONZALEZ. Thank you very much.

Well, I have one question for Mr. Dennis. There is concern—can you explain that concern that 40 percent of the loans originated in 1993 were refinances? I realize that many of those were originated without new appraisals under a streamlined refinance program.

Is the FHA at risk because they may not have an accurate understanding as to the value of those unappraised properties?

Mr. DENNIS. I think there are two aspects to the question. One of the main issues of concern is that in 1993 there was such an unusually large level of prepayments that—the type of analysis we do depends on an extension of past events, and when you get an unusual occurrence relative to the past, you have less confidence in your ability to predict into the future.

The streamline refinance loans themselves, the major concern we have is that we don't know what their current loan-to-value ratio is when they come back into the book, and that is one of the primary determinants of the risk profile of the loans.

Mr. VENTO. Mr. Chairman, will you yield on that?

Chairman GONZALEZ. Certainly.

Mr. VENTO. This is an important point. As you pointed out, 31 percent without appraisals is the issue they are raising in their summary?

Chairman GONZALEZ. Well, more or less. It is the indetermination, the unknown factor there.

Mr. VENTO. Right. I think the concern, of course, is a practical one. If you fold into the refinancing the cost of an appraisal, again, and of course, we have had some debate on this in the committee too, often it is a disincentive then for refinancing. The spread has to be greater in order to translate the refinancing, which itself then translates into a less risk loan because of lower interest rates.

So insofar as you have to factor in that particular cost, the $300 or $400 or whatever it is for appraisal with that. So that is really the question, which I don't know that your numbers can go to that particular type of mortgagee behavior.

I just wanted to add that point, Mr. Chairman. Thank you.

Chairman GONZALEZ. Thank you.

Well, also, I thought I would ask Mr. Dennis, since I believe that would be the best source, and I will go back to this question of the increase of the loan limits, the Risk-sharing Program between State and other housing agencies and the FHA, and the National Homeownership Fund which provides grants to meet downpayment requirements.

What, if any, do you feel or do you have an opinion as to the impact on the solvency of the MMI Fund of these proposals?

Mr. DENNIS. The most I could express is an opinion not based upon any analysis, which I would be largely hesitant to do.

Chairman GONZALEZ. I understand.

Mr. DENNIS. On the loan size limit, Mr. Retsinas' comments with regard to FHA's experience are correct, that within FHA's experience, the larger loans have tended to be the stronger performing loans. And all of our econometric statistical analysis confirms that.

With regard to extending the loan size limit outside of FHA's experience, we have not analyzed that. And there are a number of potential offsetting issues we would want to assess before stating an opinion on that.

Chairman GONZALEZ. Fair enough. Do you have any comment, Mr. Craren?

Mr. CRAREN. No.

Chairman GONZALEZ. Ms. Bridgers, a year ago, and after much debate, we raised the FHA loan limit once again, this time to $151,725. Since that time there have been several proposals made to raise the loan limit to as high as $172,675, which I referred to, while others would raise the FHA floor limit to more than $90,000.

Now, those proposals, if passed, would greatly expand FHA's presence in the mortgage market, while at the same time substantially increasing revenues to the fund.

And what, if any, are GAO or your views on higher FHA loan limits, their potential impact on FHA's market share?

Ms. WILLIAMS-BRIDGERS. Mr. Chairman, as you mentioned, in the past we have supported increases in the FHA loan limit, particularly as they are indexed to house price appreciation rates. So in that regard we would agree with Mr. Retsinas that there is a need for FHA to remain competitive, to also maintain its market share, and the best way for it to do that is to offer an attractive package and to offer a loan limit that is competitive with that of the private mortgage insurers and private mortgage companies.

However, we have always qualified our suggestions for increases in the FHA loan limits by saying that we think it is particularly important for the FHA fund to achieve financial solvency. The fund did not meet the capital ratio of 1.25 percent in fiscal year 1992, although Price Waterhouse—and we—believe it has since met that target.

We would strongly urge that caution be exercised before any further increases in the loan limits. We would like to see the results of another year's book of business, the performance of the fiscal year 1994 book of business to see if, with the addition of that year's value, the fund reaches its 2 percent legislative target. Then we think it would be advisable to enter into discussions of increasing FHA's loan limit.

Chairman GONZALEZ. But which comes first? In other words, if FHA doesn't increase its share of the market, so what do we do?

The subcommittee, of course, has acted, on the recommendation of FHA. But somewhere there we have to have some breakoff point. And based on the findings and evaluations of Price Waterhouse, I think I am going to let Mr. Vento, if he so desires, hit on that a little bit later.

There is one thing here, though. Along with the other measures, the National Affordable Housing Act of 1990 required that the payment of distributive shares by FHA be based on the actuarial soundness of the entire MMI Fund, and not solely on the performance of loans endorsed during a particular year of business, as has been done in the past.

In light of the substantial improvement in the FHA fund in the last 2 years, as reported by Price Waterhouse and in your statement, do you think it prudent for FHA to begin paying distributive shares once again?

Ms. WILLIAMS-BRIDGERS. Again, we would say that we would want to wait to see how the fiscal year 1994 book of business performs before making distributive share payments.

Chairman GONZALEZ. Well, in your statement you did not, unlike Price Waterhouse, provide estimates of when the fund would achieve the 2 percent capital ratio, which was mandated for November 2000. Don't say legislators aren't hopeful. Is there any explanation for that?

Ms. WILLIAMS-BRIDGERS. Yes. We felt that given the significant influence of economic factors, particularly house price appreciation rates, mortgage interest rates, that it would not be appropriate for us to project the economic net worth of the fund, and whether or not the fund would achieve the capital ratio by the year 2000. There is just too much uncertainty, as Price Waterhouse has indicated, in economic influences on the fund. So we felt it best that we not attempt to project the capital ratio for 2000.

Mr. CHERLOW. If I could add to that, Mr. Chairman, in our statement one of the factors we indicated that would affect FHA's ability to meet the 2-percent target was the demand for FHA loans and the influence of marketplace developments by the private mortgage insurers on the demand for FHA loans. There are a number of new products coming into the market, such as private insurance for 97 percent loans and not just for 90 or 95. And this could have an impact on FHA's business. Time will tell where this is headed over the next year or two. So, that is one of the reasons why we think that it would be worth waiting a little longer to make a projection out to 2000.

Chairman GONZALEZ. Mr. Secretary, do you have any comment on that? Because you're concerned about enhancing the activity of the FHA, and you are basing it on optimistic findings, both by Price Waterhouse and other general economic conditions.

Do you have any thinking on the reluctance because of the contrary opinion that there is too much flux, instability?

Mr. RETSINAS. I have a lot of thinking on this matter, Mr. Chairman. I would like to think, Mr. Chairman, that even if the Congress did not require in 1990 that FHA and the Department do an actuarial analysis, an actuarial study and projection, we would have done one anyway. It is the right thing to do, and I applaud the Congress for imposing that requirement.

As I indicated in my opening statement, certainly any projection, any projection is as good as the assumptions that are used. I am not sure that what are used are the optimistic assumptions. What are used are a whole series of assumptions.

Both Price Waterhouse, in looking at its conclusions, GAO at its conclusion, varied the assumptions somewhat. In almost every case, as I recall the testimony, except in the very worst-case scenarios, the capital ratios are met in this year. The capital ratios are projected to be met with an extra margin, an extra cushion, in the year 2000 in every case.

So, certainly, if one is to question the assumptions then one, by definition, is questioning why bother to do a projection in the first place. Any projection is required to depend on assumptions.

I have confidence in the quality and capacity of the firms undertaking the review. Price Waterhouse is certainly a legitimate, nationally recognized firm. The economic forecast that is used by DRI is used not only by this government but by State governments and private businesses all over this country and the world.

So it seems to me there is at least a credible assumption that these assumptions make sense. Certainly, it needs to be looked at. That is why I believe the Congress should act to conduct this review annually. The housing needs of this country must be addressed. So we need to keep looking at it to determine whether or not we are making progress, whether there is that capital ratio that Congress prescribed.

Chairman GONZALEZ. I notice you didn't refer to Chairman Greenspan's statement that never has the economic status of this country been as good as now. Maybe perhaps that was an untrustworthy source or what. But he did come out with this very ferocious statement as to the well-being. And so I realize that.

But I want to remind everybody here that in 1929, in May, President Hoover had appointed these prestigious experts and business leaders, and they came out with a statement saying that for the foreseeable future there was nothing but unlimited progress and economic well-being. Of course, history wrote a different result.

So I realize when we come to applications and all—but I also realize that we have been through this, and I think the one thing that hasn't changed is the so-called private market. As I said during the debate on these limits, there is no place I know of, including my relatively low economic as compared to other areas of the State activity, where there are brand new homes being built for much less than $100,000. That is tragic, because in 1984, that is

10 years ago, I met with a member of the Japanese Diet who had a corresponding position, and also a Japanese industrialist builder. They assured me that they could come into the United States and build a modest single-family unit, put it on the lot, cap the interest at no more than 7.5 percent at that time, and at no higher cost than $10,000.

So I then said to the group of mortgage bankers and whatnot out of New York, that what I think is going to happen in our country is what happened in the automotive industry. That was wait until we get the Volkswagens and the Japanese imports at what was comparative at the time, competitive and attractive to the American consumer. And the fact remains, though, that if you are thinking in terms of new single-family construction, that is the price level that you are going to have to face.

So I thought that it was reasonable for those advocating in the high cost areas the increase. It was a very bitter argument. It had to be 1980, because I wasn't chairman of the subcommittee. Mr. Ashley was. And I remember all the agonizing then, and the same arguments.

But anyway, with that, I thank my colleagues and recognize Mr. Baker.

Mr. BAKER. Thank you, Mr. Chairman.

Before I make any comment to the panelists, I just wanted to briefly express my perhaps extreme admiration for the chairman's tenacity in legislative process. I am reminded of that great figure in American history, Andrew Jackson, later figuratively referred to as "Stonewall." After 5 days of legislative torture, I feel more like a brick myself, but I have to tell you that you are indeed a stonewall in the legislative process.

Mr. Retsinas, I want to express my comments to you and assure you I will not talk about the Federal home loan bank, recent correspondence, nor the Fourth of July, but all are related to the great fireworks we expect in the future.

Mr. Greer, I want to make a comment to you concerning your recent activities and interest in the matter concerning the Desire Street Housing Project and your comments with regard to that subject.

But all of the panelists, I appreciate your participation. I want to speak directly momentarily to Ms. Bridgers respecting some observations in her comments.

I found it unfortunate that prior to the committee's recent most precipitous actions with regard to loan limits in the FHA Program, we did not have the advantage of the Price Waterhouse report in our possession prior to taking the direction which the committee most recently took.

I have just been told by a person in the market here for a home that a realtor recently advised him that there was a new 1 percent program, mean interest rate, which would finance 99 percent of home value. That is a new product soon to be offered in the market under the Homeownership Trust Fund. I found that to be extraordinarily concerning.

The first question, is it your experience from a statistical historical perspective, is there any correlation between an individual's personal assets involved in a transaction and the likelihood of foreclosure or failure to meet obligations and an individual's ability to get a low equity position and a mortgage obligation and his likelihood of walking away? Are the two things correlated in your view?

Ms. WILLIAMS-BRIDGERS. Do I understand your question to mean, is there a correlation between the percentage of downpayment that a borrower——

Mr. BAKER. Yes.

Ms. WILLIAMS-BRIDGERS. Yes, we found that higher loan-to-value ratios, loans with higher loan-to-value ratios have a greater likelihood of default.

Mr. BAKER. Given that, I want to outline what I believe to be—if I am inaccurate if my assumptions, please correct me—there was an apparent increase in cash-flow deficits in the MMIF Fund from 1992 to 1993, from a loss of $143 million to an accounting of $163 million in net loss in 1993. While net revenues did offset those losses, the net revenue gains in 1992 were $292 million, in 1993 they were down to $12 million.

I found with great interest the fact that in 1992 and 1993, proceeds from redemptions of investment securities and the FHA's balance sheet in 1992 was $1.18 billion, in 1993, $2.59 billion. If it had not been for the redemption of investment securities both years, we would have found ourselves in an embarrassing difficult circumstance, meaning that the underlying mortgage management asset generating capability of the agency is losing money.

Now, in light of those 2 years' historical data, and the fact that we have been at an incredibly low-interest rate environment where those who could have the option afforded to them, perhaps 5 percent down, let's assume someone has been in an FHA-financed property for 3 or 5 years, could sell it in a very good environment where a private purchaser could acquire it and get the borrower and the FHA Program out, give him a little equity, he could put it in a private mortgage opportunity somewhere else.

I found that FHA's comment, Mr. Retsinas' comments in testimony prepared for this morning's hearing, where we found that his comment was that "many folks who guided FHA in the 1980's were high-risk loans," meaning they couldn't meet standard private mortgage requirements to get a loan, probably got out during this unusually aberrant low-interest rate environment we were in.

My view is somewhat a little contrary, that those who could get out of FHA Programs in this usually low-interest rate environment, did. The residuals are likely to be people who had no cash, whose debts went up and who couldn't take advantage of the 6, 7 percent mortgage rate environment we are in. So the residual pool may be more highly leveraged than this market.

Given the fact that this subcommittee has greatly expanded the floor and the ceiling of the FHA's mortgage lending opportunities, has at the same time reduced up-front premium requirements, during a period of time when interest rates were extraordinarily low, given the parameters which I have now framed, and the 2-year historical data on revenues generated on sales of securities rather than underlying mortgage performance, how do we reach a conclusion that we are in good shape?

Ms. WILLIAMS-BRIDGERS. Let me try and break apart several of the questions that you have asked.

Mr. BAKER. I will provide copies for you later.

Ms. WILLIAMS-BRIDGERS. I will also ask for the assistance of my colleagues here. One is the first analysis you referred to, I think you were referring to the cash balances that exist in individual years. Our work looked at the actuarial soundness of the fund. Therefore, we did not do a financial audit. And I would defer that question to Mr. Craren and Mr. Dennis, because they did do a financial audit.

But I think one of the points that you are making is that the actuarial soundness of the fund, the cash balance of the fund, are in fact dependent on the interest earned on investments made by FHA, that the expenses or claims that are paid out are covered by revenues generated not only from the premiums, but also from interest earned on investments.

But the rest of that question I will defer to Price Waterhouse.

On a second point you were making about the refinancing and whether or not FHA after the most recent year of high repayment activity is left with the more risky mortgage loans, in part that question was answered a little earlier in that we don't have much information or we don't have any information, really, on the loan-to-value ratios, and therefore we cannot reliably assess the risk associated with those that refinance that are still with FHA.

I think you have to look at it as three groups of people when you talk about refinancing in FHA. You look at those borrowers that had high-interest rates and did not take advantage of refinancing opportunities in fiscal year 1993, and we know that those people do have risky loans. We know that is risky business. And for reasons, as you said, probably those people who could refinance did refinance, if they had the assets to do so.

There is a second group that you need to look at, and that is those with the high-interest rates that did refinance but stayed with FHA. The third group is those that refinanced out of FHA and got a conventional market. It is those latter two groups that we don't have the information on, because through streamline refinancing, there were no appraisals, so we don't have any information on the loan-to-value ratios of those loans.

Mr. BAKER. Just a couple of followups. One is that I am of the opinion, and I don't know that it is shared broadly, that there should be a demonstration that the market is not meeting a particular mortgage need before the government steps in and provides a response program.

In my view, the higher mortgage loan limit increase was particularly questionable in light of the fact that there are new products being developed almost daily in the market, and we have very little experience with regard to extension of FHA Program from such a precipitously high increase, as we recently took in light of the fact, historically, those demands or needs have always been met.

If the arguments are correctly made by proponents of the measure that higher income individuals who make higher mortgage contracts are lower risk, that to me means that the free market ought to be running to that end of the marketplace if those folks are correct that the market responds to profit.

If there is profit to be made, why should we be in the business of federalizing what should be a private mortgage responsibility while we at the same time are dramatically increasing the risk of Federal taxpayer involvement in this matter without having historical data to tell us we are correct?

No response to that. Thank you.

Mr. Chairman, I am sorry, I just perhaps give Price Waterhouse the chance to respond, since the gentlelady did——

Mr. CRAREN. With respect to your questions about the cash-flow, which you correctly pointed out were negative in 1992 and 1993, I guess my comment would be that that is relevant, but it can be a deceptive measure. For example, in 1984, when the MMI went to the up-front premium, a lot of cash flowed in, but I guess in retrospect it wasn't such a wise thing.

Mr. BAKER. Let me ask one question just by way of example. Let's assume I am an automobile dealer going to my bank to expand my marketing opportunities. We look at my balance sheet and I have been losing money selling cars but my family is wealthy so I have been taking money out of my family's CDs. Now, I ask you for more money to put into my losing car operation because my family is wealthy. Does that make business sense to you?

Mr. CRAREN. It doesn't, and there is no question you should be concerned about cash-flow numbers. All I am suggesting is you need to put them in some context.

Mr. BAKER. And what is that context?

Mr. CRAREN. In 1992 and 1993, for example, and this is a comment I made in my statement, in exchange for the claim payment, rather than taking a property and selling it, FHA began to take a much more illiquid asset, a loan which it couldn't turn around and sell for up to 3 years in some cases, and that impacted its cash-flow.

Now, is that something to be concerned about? Yes. Does it necessarily spell disaster for the fund? Maybe not.

I think you have to look at cash-flows not just exclusively but in the context of the actuarial analysis and in the context GAAP determined income or loss.

Mr. BAKER. But given the market difficulties of the product, is this a time when you would recommend expanding our market share?

Mr. CRAREN. Again, I think it is not exclusively a financial consideration. I think people have brought up policy concerns, and I think those have to be balanced against concerns about the financial health of the fund.

Mr. BAKER. Thank you.

Chairman GONZALEZ. Mr. Vento.

Mr. VENTO. Thanks, Mr. Chairman.

I am pleased with the response. I was listening to Mr. Baker and I wanted to say before he left that contrary to being a precipitous action in terms of dealing with the limits and modifications to FHA policy, I would suggest it was very deliberate, waiting on the audit. It is true he didn't have the total report, but now you have the report, and I think the report sustains the audit and, obviously, each of us need to study it more carefully.

But I would just suggest further, in terms of, you know, philosophy or policies, that the FHA, as Mr. Retsinas said, has basically shaped the modern mortgage market. It was a precursor in 60-year history. So, clearly, if the private sector was going to get out there and do it, and it has done it in some cases, it really is following. So I think there is, obviously, a free exchange or a borrowing of ideas back and forth that go on. But I think that FHA has a critical role to play.

The issue about up-front premium in the early 1980's that became law, and the loan-to-value ratio and the effect of that, all of that has a very significant impact, in my judgment, and it happened in 1982; I was here. I was involved and concerned about the impact of that. It had a positive effect on the budget deficit. But the question is, that is like spending fire insurance the first day you collect it.

That doesn't tell you what the experience is going to be over the life of those mortgages, whether it is 7, 8, or 9 years average, and maybe some of the bad ones, longer.

The point is, Ms. Bridgers, you raised the point about the nature of the fund, in terms of what the cash value is. But the cash value is looking at it, as was suggested, in a given point in time. It doesn't look at the extrapolated risks that are associated with that. So your statement really doesn't reflect whether or not we reduce up-front premiums.

Specifically, you pointed out that when up-front premiums were reduced, or if they had been reduced even more, the impact in terms of the audit statement would reflect a slight decrease in the value of the fund. But that has to be balanced, does it not, against what the risk exposure is in terms of paid insurance versus unpaid insurance.

Do you understand my question?

Ms. WILLIAMS-BRIDGERS. Yes.

Mr. VENTO. You made the specific statement about the fact that if the premiums were dropped, they were at 4 percent, then they went to 3 and then 2.25. You said if they were dropped the actuarial statement would have less dollars in the fund. But that would be reflected in a risk premium that would be collected on an annual basis or on a payment basis insofar as it was reflecting the same percent.

In other words, the transition was to a higher risk based premium, a higher annual premium that is paid in a monthly payment. And so that would mean you have a revenue of loan coming in paying for the insurance in effect as opposed to prepayment. So looking at this, the audit statement tells you about insurance, in effect, but it doesn't necessarily speak to the revenue flow you will have coming in the future that is assigned to that particular category of loan.

Would you please give your name for the record again?

Mr. CHERLOW. My name is Jay Cherlow. I am an economist at GAO. I will try to respond to that. You are right, of course, that both the up-front and the annual premium payments are both important factors. Our actuarial soundness work considers the annual payments that are going to come in as well.

When we look at the future cash-flow streams, we are looking at both premium income that is going to come in for the years since we resumed having an annual payment on the most recent books of business, as well as the books of business pre-1983, when there was an annual payment.

And we look at that as well as payments that are——

Mr. VENTO. I know you look at them. But the statement is that the audit statement would show less money in a given year. That statement is accurate, but it doesn't necessarily deal with the dynamic of what is taking place when you make that statement. You have to look, or you have to consider that in light of that as the premium changes.

I mean, the real question here, and the question the Congress came back and answered and said, We don't want a big up-front payment because we think in fact the type of phenomena that occurred in the 1980's was due to a big loan-to-value ratio, and the adverse collection that occurred at that time because you also had restrictive loan limits.

Can you speak to that?

Mr. CHERLOW. There certainly can be a tradeoff between an up-front premium and the annual premium. And I am not sure I entirely understand your question, but I think that you are saying that if we lower the up-front premium, we would have to consider trading that off against increasing the annual premium.

Mr. VENTO. That is the way it actually functions. That is the way we wrote the law.

Mr. CHERLOW. That is right. In our statement, the specific number that we provided did look at what would happen if you lowered the annual premium without further additions to the annual premium than what is currently in the law.

Mr. VENTO. Well, I understand what your total statement does, but in a given sense, if you are just talking about a snapshot of it, an audit snapshot in terms of what the reserves are, it does not look at that. In other words, you have to take into consideration other factors. You did take it into consideration. I am just saying you make a statement in the audit about the premium being reduced, it has to be considered in that particular context. That is all I am trying to point out.

Let me ask a question of Mr. Craren. Mr. Craren, on page 43 of the report, you talk about initial loan size distributions. What I am interested here in, of course, is you have pointed out the FHA experience indicates that all else being equal, larger loans tend to perform better than small loans. This may be explained in part by the higher borrower income requirements for larger loans.

Do you want to elaborate upon that particular indication? Because there was obviously contrary information being provided at various times in this discussion concerning higher borrower loans.

I think there is a differential here, I might say myself, of what I would call the jumbo mortgage type of loans, which are obviously outside of anything that was legislated or is anticipated to be legislated with regards to FHA. So the higher borrower income requirements and larger loans, if you talk about that, and why FHA needs that type of subsidy type of involvement.

Mr. CRAREN. I will ask Mr. Dennis to address that.

Mr. VENTO. Mr. Dennis.

Mr. DENNIS. With regard to the cross-subsidization, I would rather direct that to Mr. Retsinas. I think that is more of a policy-oriented issue.

But with regard to the statement on the relationship between the loan size and the claim rate, that is very specific to the loans within the FHA, the MMI Fund. We are not meaning to extrapolate that beyond the loans in the MMI Fund, to larger loans or even same size loans outside the fund.

Mr. VENTO. But your experience is the higher end loans actually, in fact, have less of a loss attributed to them than the lower loans in the current portfolio?

Mr. DENNIS. Yes.

Mr. VENTO. And you have not done anything to extrapolate or pick information from other size loans, is that what you are saying, for other loans that are outside that portfolio?

Mr. DENNIS. That is right.

Mr. VENTO. Mr. Retsinas, what about the cross-subsidization that goes on here and why is that important, to increase the size of the portfolio along those lines?

Mr. RETSINAS. I believe it is very important, Congressman. As you know, this is an insurance fund. It is an insurance fund where risk is not even throughout the portfolio. And, from our own experience, as Mr. Dennis indicated, within our current portfolio the higher loans generally have a more positive impact on the fund than the lower balance loans.

I believe that by an increase in the loan limits, a prudent expansion of the FHA Mortgage Insurance Program, that will increase the solvency of the fund. And once we continue to be assured of its solvency, we continue to use the fund as originally intended by Congress in 1934, which is to make it possible for American families to buy homes that are unable to do so in the private sector.

So we think this insurance fund is really a kind of financial miracle by the Congress in the 1930's to come up with a way to support homeownership without special government appropriation of subsidies. We believe bringing it current to 1994 is a way to further those original aims.

Mr. VENTO. One of the concerns here, of course, in the last year has been the significant runoff in FHA portfolio. In your opinion, one of the chief causes, is this phenomenon a source of concern?

Mr. RETSINAS. I think the chief cause, of course, of refinancings generally, of sales of properties, is the interest rate environment. Heavy refinancing occurred throughout the marketplace, both in the private marketplace and the FHA-insured marketplace.

As Mr. Craren, I believe, indicated, we do not have the specific information on the specific characteristics of the borrowers who left FHA. It is important to note on the matter of streamlined refinancing, which I believe, Mr. Chairman, you asked a question about that we are talking about streamlined refinancing of loans already insured by FHA.

If those refinancings had not taken place, we would still have an insurance liability. What we have done, of course, is lower the debt service on those loans. And I believe that so doing would increase the solvency of those same loans. So I think there is some concern because we don't know the details of the borrowers. But it would appear that it has not had a negative impact on the value of the fund.

Mr. VENTO. Mr. Chairman and members, one of the concerns expressed here by Price Waterhouse and one of the points you emphasized, Mr. Chairman, is the weakness, there are certain weaknesses in the FHA, but in looking closer at this description of these items in your testimony this morning, it sort of suggests that FHA needs to be more responsive, and that some of this responsiveness or lack of responsiveness comes on account of needed legislative changes to respond or administrative changes that are, you know, inherent to the system that actually slow it down; the time for the Administrative Procedures Act, the time for Congress to act on legislation, the budgeting of staff and personnel, computer systems.

It seems to me the issues and rules with regards to the disposition of property, now, I think all of you, maybe the GAO has also spoken to this particular issue. Last year, the year before, we in fact provided separate office status and regulatory function to the FHA, a rather dramatic rewrite of the organizational structure of FHA in 1992.

The chairman, myself, other members, were deeply involved in this in terms of treating it almost as a Government Sponsored Enterprise—but the point is, do we need even more autonomy here? Is that what you are really saying?

I guess I can start out with the Assistant Secretary. Do we really need more autonomy and independence in order to be current, in order for FHA to really be responsive?

Mr. RETSINAS. Congressman Vento, that is precisely the question Secretary Cisneros asked me to look at. To answer the question the best way I can; that is, are we appropriately structured to carry out the mission that FHA was empowered to undertake, today in 1994 and through the balance of this decade and the years ahead?

If I were to give you the conclusions, I would prejudge the results of the meetings and forums and dialog I expect to undertake. But I believe, Congressman Vento, you are on target.

There are significant constraints and significant procedural matters that are barriers to the kinds of reforms that we need to undertake that will make us more responsive to the marketplace.

So I agree with one of the conclusions in the Price Waterhouse audit, which indicated there are many new plans for improvement. I believe we have some good plans. But, certainly, the current structure can be inhibiting in carrying out those plans. Chairman Gonzalez mentioned one of them.

The restraints on the hiring and engagement of additional personnel to do the business of the agency. Those are restrictions that are imposed on the Department and within the Department on FHA. And they certainly are inhibiting factors as it relates to the conduct of the insurance fund.

Mr. VENTO. Mr. Craren.

Mr. CRAREN. We have always been concerned about divorcing money spent on the MMI Fund's credit management from money generated or used by the loans themselves, and then putting caps on the number of administrative people who run the program. The two should be linked.

Like any credit institution, things happen at FHA that sometimes require more staff or new systems, and sometimes FHA must rapidly respond to changes in the market. Yet, when you have some other body controlling not only the number of people you can hire to address a potentially serious credit problem, but also your ability to upgrade your systems and modernize them in accord with the marketplace, then we think this is a rather dangerous situation.

Mr. VENTO. One wonders what happens if you take your percentage cut of the employees over the next 5 years and you have an increasing size portfolio that is going on. But part of the problem was this whole attitude during the 1980's, collecting the premium up front, we have got our money, and not worrying what happens with the portfolio was not a very good idea that Reagan and other administrations in that policy path that Congress let happen, which again I think is a mistake, or some of the issues in terms of—obviously this relies upon the strength of those area offices.

With the MMI Fund we have a very strong office arrangement and very strong outreach technique, although not perfect, in the sense that you talked about the criminal activities, the fraud and abuse that is going on.

But I guess the real concern here gets to be, outside of those direct administrative things, whether you have the right computer, the right disposition program, is that fundamentally are we screening or do we have adverse selection being caused by the types of requirements in terms of loan limits, by the requirements in terms of inappropriate up-front premium, decide maybe politically, or by 2,200 pages of application process to get a loan. That is a deterrent, too, to people.

And any type of documentation, Mr. Craren, did you have anything you wanted to say about adverse selection risks based on the law or the limitations of FHA, especially with the MMI Fund is what I am talking about here.

Mr. CRAREN. If it is administratively cumbersome, and thus could contribute to losing some business that you might want to have. We don't know specifically how much that exposure is, but certainly, it is something to be concerned about.

Mr. VENTO. Well, I mean, if you have provisions for an increase in the insurance premium, if you change the loan-to-value ratio, these are the issues obviously that we can deal with, changes in downpayment requirements, impact of complicated formulas. All of that has, in my judgment, some impact in terms of who is going to walk through the door. You aren't going to do this, it isn't as convenient, you are making it inconvenient, you are making it overly burdensome. We are dealing with 66 percent, as you said, with first-time home buyers.

Ms. Bridgers, did you look at any of these issues?

Ms. WILLIAMS-BRIDGERS. No, we have not looked at the issues of adverse selection, but we applaud the Secretary's efforts and direction to Mr. Retsinas to begin examining the role and structure of FHA.

When we speak about the condition of the Single-family Housing Program, the numbers that we have all discussed this morning give us one picture of the financial solvency. But the capacity of FHA to manage the program, whatever its structure, is extremely important for us to begin paying attention to.

Whether or not FHA's workload is appropriate, whether it has the staff resources to attend to its workload, and whether or not those resources are allocated to the particular program areas where monitoring and servicing are most needed, are all questions that need to be thoroughly examined in order to make improvements in the fund as a whole.

Mr. VENTO. Mr. Chairman, just one more question for the Price Waterhouse and GAO, and I have to go to an interview on military overflights. In any case, the issue here is, are we into a situation today—I mean, this is the fundamental question all of us are asking ourselves, we had this phenomenon that occurred in the late 1980's and early 1990's where it was very volatile—are we in a circumstance today where there is going to be inherently in the portfolio more volatility than there has been in the past?

I mean, what is—I guess, asking some sort of opinion, you spent years and your staff in terms of reviewing that, and I think it is just a fundamental question that we need to look at from the standpoint of Price Waterhouse for the last 5 years with models and from the extensive experience with the Secretary, and what do we do in terms of policy if we are—we have obviously done one fix, administratively done some other things, we think the policy path we are on is correct.

I would argue, certainly, that it is a step in the right direction. But, Ms. Bridgers, could you speak to that volatility question?

Ms. WILLIAMS-BRIDGERS. I would like to defer to my colleagues on that.

Mr. VENTO. Please do, to both of them. I am sure they both have a view with regards to that.

Mr. CHERLOW. I think, Congressman, you make a very good point on the volatility. This is part of why we are being very cautious in making any projections out to the year 2000 on the capital ratio or with respect to raising the loan limits further at this time until we have a little bit more experience.

As Mr. Craren said earlier, a considerable extent of the value of the fund today is dependent on the performance of the 1992 and 1993 books of business, on which we so far have very little experience. We have projections——

Mr. VENTO. But I think Price Waterhouse's initial reactions that were coming back negative were very much dependent on the book of business in pre-1985, which were very high, and were skewing it a different direction, if this is skewing it. Please proceed.

Mr. CHERLOW. And with the large wave of refinancing that took place in the last 2 years, a lot of the old loans are no longer on the books, and last year's book, as you know, was a very large book of business and is going to continue to have a large influence on the fund for many years.

Until another couple of years pass, we really are just making projections on that book. When we have a little bit more experience on how that book is actually performing, I think it might be the time to revisit this and feel we are on a firmer basis to estimate on what is going to happen over the rest of the decade.

Mr. CRAREN. I would say the concern about economic volatility is why we came up with a specific capital ratio for the MMI Fund. We were uncertain about what was going to happen, and therefore it is proper to build a cushion some way. Congress ultimately did this through raising the premium and tightening up underwriting. That was the intent of it. I think it is certainly appropriate to reexplore these factors every year and look at actual performance in light of what we projected.

Mr. VENTO. Mr. Retsinas.

Mr. RETSINAS. I just would reiterate, I think Mr. Craren's point is well taken. If there were no volatility, if we could predict the future with certainty, we would need no capital ratio. We would know precisely how much is necessary to move forward. The fundamental purpose of a capital ratio is to establish a cushion. The value of that cushion is in part dependent on the value of those who are forecasting.

I have confidence in the abilities of the firm and the work they have done, although I am sure I can't guarantee the accuracy of their assumptions; but, at some point if you are going to make projections, you are dependent on assumptions.

Mr. VENTO. Obviously, you can eliminate all the risk by closing this program down. I guess that is the other side of it. So we know there is going to be a substantial amount of risk. But the question is, basing that on a broader based market of homes, a cross section, it seems to me—you know, if we don't respond to demand, if we don't—then we obviously—the market's needs are not going to be met. So there is so much of a case here where this particular program has shaped the market, too, that it becomes very, very important to it.

Mr. Chairman, thank you for your patience.

Chairman GONZALEZ. Good luck. Is it on Whitewater?

Mr. VENTO. No, Mr. Chairman, it is not.

Chairman GONZALEZ. Well, it is really "yellow water" by now.

Mr. Knollenberg.

Mr. KNOLLENBERG. Thank you, Mr. Chairman. Thank you for holding this session, because I have listened very attentively, and I have heard a number of things. Some things bother me, particularly when I hear that we can show a balance statement in the black while the operations appear to have a negative cash-flow.

Most companies in the private sector include operating expenses in their balance sheet. I heard the testimony, but I am still bothered by the answer I got.

I am further bothered by the answers we got with respect to the potential with all of the refinancing activity. I understand it was four to five times greater in the last year than it had been anticipated. And I know, Ms. Bridgers, you categorized it into I believe it was three categories, and the studies are really not very conclusive as to what precisely kind of risk is involved here.

Did some of the better mortgage holders move on, move out of FHA-financed housing and into conventional housing because of rising assets or income or whatever? That bothers me.

It bothers me further that on top of all this, what we are doing is I think perhaps maybe even unwarranted, an intrusion into the area of the FHA single-family mortgage insurance, raising those limits to as high as we have here, to $172,000. I noticed over in the Senate they have got a little more conservative view of this. They have frozen that pretty much at $152,000. That is the upper limit, and the bottom limit is $77,000. Here we have it at $101,000.

I recognize by increasing those loan limits we are going to generate more loan revenue. But we haven't done much in terms of studying what kind of book of business we have got. We have only got $124,000, that was just 3 years ago. Now we have had 3 years of dealing with $151,000. Now we are going to $172,000.

It strikes me that the Senate may have some logic about this by, I believe, resisting—it appears to me they are resisting going to the higher limit. So I am concerned about all of those things and I am concerned about the risk to the taxpayer.

The question for Mr. Craren, I think I heard something, and I don't know if it was for you or somebody else, that as you increase the loan limit—maybe I should rephrase it—if you increase the loan limit, what does that do to risk? I don't think I got a clear answer on that. I am going to ask it again.

Mr. DENNIS. That is right, you didn't get a clear answer from us because we haven't studied the issue enough to be able to be in a position to give you an answer on that question, outside the experience of FHA. Within the experience of FHA, it is clear that the larger loan sizes are the lower risk loans.

Mr. KNOLLENBERG. Larger loan sizes are lower risk?

Mr. DENNIS. Within the experience of FHA.

Mr. KNOLLENBERG. Up to what level?

Mr. DENNIS. The highest loan level.

Mr. KNOLLENBERG. One hundred and twenty-four?

Mr. DENNIS. Yes.

Mr. KNOLLENBERG. You really haven't done a study on 151, right?

Mr. DENNIS. There has not been nearly the experience with that home size.

Mr. KNOLLENBERG. Let me ask this question, then. Isn't it true in the private sector when you are talking about increasing the level of loans that the risk rises with the volume of that loan?

Mr. DENNIS. As I understand it, there is some evidence that as you increase loan size risk tends to fall up to a point at which it starts tending to rise again, especially when you get into the jumbo loans.

Mr. KNOLLENBERG. So you are saying there is some of this?

Mr. DENNIS. There is evidence to that effect. I think there is also evidence reported by some that contradicts that.

Mr. KNOLLENBERG. I understand how excited you might be about increasing revenue, Mr. Retsinas. It would go up, obviously. But with the lack of study as to what kind of risk you are actually assuming, and I guess we are moving forward pretty quickly here into an area of increasing loan values without really looking closely at the risk associated with that.

So with all the other problems that we have, and with all the concern I have about the taxpayer, and I am sure everybody here does, aren't we moving a little quickly without looking retrospectively at where we have been and just where these—first of all, the inventory of risk that we have, what with the outfinancing or refinancing and moving on up, are we left with a heavier load, let's say, of low- or high-risk loans, at the same time combining the idea of increasing loan limits, which does bring in revenue, but it also brings in risk that seems to me may be a lot more than we expect?

Mr. RETSINAS. There are a couple of points. I will try to comment on all of them. I, too, am concerned about the exposure to the American taxpayer. I have a responsibility to ensure there is no undue exposure. I have a responsibility to carry out the legislative mandate of this subcommittee and this Congress, which is to ensure that the fund be self-sustaining.

That is why, over the course of the last year, we have done all that we could, and we need to do more, to ensure the solvency of the fund. And I am pleased with reports of Price Waterhouse and confirming reports of GAO in terms of the progress that has been made; although to repeat, I understand its future progress is dependent on the accuracy of the assumptions.

As it relates to the issue of the expansion and increase in loan limits, I certainly respect, Congressman, the deliberative process the House went through in coming to that conclusion. I have the experience that Mr. Dennis alluded to, that if you look carefully at the history of the FHA portfolio, the evidence is pretty clear, is abundantly clear, that the higher loans generally have more of a positive impact on the fund than the lower loans. The market evidence Mr. Dennis alluded to is sketchier.

Mr. KNOLLENBERG. What is higher, 124?

Mr. RETSINAS. Within the experience at FHA.

Mr. KNOLLENBERG. And 67?

Mr. RETSINAS. Generally speaking, there is a correlation. I have been handed a chart which you probably can't see, but it is a pretty straight-line correlation in terms of the higher loans have lower cumulative claims rates, which I can share with you.

Mr. KNOLLENBERG. If you would, please.

[The information referred to can be found in the appendix.]

Mr. KNOLLENBERG. We have already heard some pretty expert people on testimony we don't have, yet you just made the statement that it does appear abundantly clear. You said that there is a better risk involved with the higher loan limit.

Mr. RETSINAS. Let me repeat in case I was unclear in what I said. What I said was based on the experience of FHA, based on our portfolio, it is abundantly clear that the higher the loan, generally speaking, the lower the claims. That is the experience of FHA.

Mr. KNOLLENBERG. But you have less of those higher end loans in place. They have only been over a very short period of time, too. So the judgment period is much shorter, is it not?

Mr. RETSINAS. No, because we have had loans in differing amounts throughout the history of FHA, and the correlation is between the sizes of the loan and the claims rate. The relationship holds for all books of business.

Mr. KNOLLENBERG. I would like to look at that. If you would very kindly submit that. I would like to analyze that. I think that concludes my questioning, Mr. Chairman. Again, thank you for——

Chairman GONZALEZ. I just want to point out, Mr. Dennis referred to jumbo. FHA doesn't do jumbo.

Mr. RETSINAS. We do not.

Ms. WILLIAMS-BRIDGERS. Mr. Chairman, may I respond in part to the Congressman's questions about experience with higher loan limits.

We do have a different set of experiences that we can borrow from the VA Guaranteed Loan Program. We have looked at mortgages that have been guaranteed by the VA. The VA has allowed a higher loan limit than has FHA for some period of time.

Specifically, VA had a maximum loan ceiling of $144,000 in 1988, and $184,000 in 1990. When we have examined the default rates for those loans, we find that the scenario is very similar to that of FHA's. The larger loan size generally experiences less default rates.

It has a lower default rate for the larger loan sizes under the VA Guarantee Program. So we have another set of experiences we can borrow from.

What we have not looked at is the underwriting standards and whether they are comparable under the VA Guaranteed Program as they are under FHA. That is a significant piece of information you would have to consider in looking at the true correlation between experience under VA and FHA.

Mr. KNOLLENBERG. Thank you.

Chairman GONZALEZ. Mr. Watt.

Mr. WATT. Thank you, Mr. Chairman.

I apologize to the chairman and the members of this panel for being unable to be here earlier for your testimony. I hope I don't ask any questions that you have already addressed.

I am looking at a slightly different area of concern, and wanted to raise some questions having to do with the audit report, specifically the parts of the report on pages 21 through 24, which have to do with the Secretary or the Department resolving Secretary-held multifamily and single-family mortgages and what disposition is being made of those mortgages where I assume foreclosures have already taken place or default has already taken place, and the loans have been put back under the Secretary's jurisdiction by whatever process.

And just reading some things I have underlined here on page 21, the number of assigned multifamily and single-family assigned notes continued to increase. This is based on the 1993 audit.

Number two, the servicing of these portfolios has been deficient, due in part to their size and growth.

And three, the effort required to service assigned notes, even though it has been deficient, has drawn resources away from servicing insured mortgages.

Down lower on the page, as of September 30, 1993, FHA had $7.8 billion in assigned multifamily notes, of which $6 billion or 77 percent were nonperforming. A large number of nonperforming notes is significant, for whatever reason. Making this buildup default in assets even more serious is that HUD has had statutory and budgetary impediments that have prevented it from foreclosing on the mortgaged property, even in those cases where the economics underlying the note make other plans impractical or unfeasible.

And on and on and on. And then you get to some suggestions. And then on page 24, there is a chart which suggests that HUD has not done anything about this, that they have put a series of plans into effect, but if you look at that chart, no implementation of those plans has taken place.

I guess my question is, in light of all that, did we have any indication that any of this is improving? Has the decline in interest rates during 1993 helped that situation? And can somebody help to set me at ease that things are not as bad as this report indicates that they may be?

Mr. CRAREN. Perhaps I will let Mr. Retsinas respond to the actions FHA is taking, but our concern is, first of all, notes assigned to FHA roughly doubled over the last 5 years, in both the multifamily and single-family areas. And the single-family area increased predominantly because of the Temporary Hardship Program. We think this is a result of the recession. And we think that there are some other things FHA could do that would be more efficient. And when you double——

Mr. WATT. I take it that is as a result of the recession and relatively high interest rates during that period, or are the rates not a factor? It is my assumption if interest rates go back down, then that doesn't help.

Mr. CRAREN. To the extent this decline reflects overall improvement in the economy, there will be fewer note assignments in the future, because, among other things, debt service gets easier for borrowers. So we think the number of new notes being assigned to FHA will decline.

The problem is FHA is stuck with what they have right now, and this still has to be dealt with. I would also add that a lot of the multifamily note assignments came from the Coinsurance Program, which was pretty much of a debacle.

But our concern, again, is that whenever you have this many assets and this rapid doubling of them, it puts a strain on the staff resources. And our concern was if it also detracts from some of the other new initiatives to shore up the fund, such as an early warning system, this will weaken the FHA's overall internal control structure.

So we are encouraging some rapid action to go about curtailing both what FHA has on the books now and what might come in in the future.

Mr. RETSINAS. If I could make a couple of comments, first of all, thank you for your observations. I wish I could say—I have now been in this position a little over 1 year—and I wish I could say I came into the position with a clean slate. I have certainly not at all underestimated the severity of the problem and the depth of the problem that is facing this country and this administration and this Congress.

Let me focus on the problem you pointed out, and some of the specific actions we have taken in part with your support. You pointed out in your review of page 21 the increase in the multifamily notes and the multifamily properties, the foreclosed properties, the delinquent properties.

When I was sworn in as Assistant Secretary, last year's audit pointed out the severe problem and the peril that we face with our multifamily insurance portfolio.

In large measure as a result of that audit and more significantly in the response to the underlying problem that the audit described, we, within the first 45 days of my tenure, introduced multifamily property disposition legislation to remove some of these impediments. This subcommittee considered, debated those initiatives, and balanced the need to take us out of that hole with appropriate public policy concerns.

And I certainly applaud this subcommittee that passed that legislation earlier this year; within the last 2 months, I believe, it was signed by the President and is now law. So some of the impediments referred to here have been removed, although not all. As it relates to the disposition of the notes, I concur with Mr. Craren's analysis.

As a result of that, we have embarked, not planned, but embarked on a note sale program. As recently as last week we began the disposition of some of our notes. Last week we sold over 15,000 single-family mortgages. We have an aggressive plan of note sales of our multifamily mortgages. That will begin later this summer. It takes time to do that, in part because of what I think are appropriate administrative review procedures.

We are subject to the Administrative Procedures Act, as Mr. Vento pointed out, which means we have a lengthy regulatory process, but that is OK because people need time to comment. But now we are going through that process, we are beginning to take action.

I don't want to make you believe we are out of the woods. Far from it. There is still much work ahead of us.

Mr. WATT. Let me connect up part of what you said with the concern, and I guess I ultimately by voice vote voted for the raise in the limits.

Mr. RETSINAS. Thank you, Congressman.

Mr. WATT. But let me just make an inquiry about what it is you are selling. I note on page 23 of the report, there is a paragraph that says, "As with the multifamily 221(g)(4) Secretary-held mortgages, HUD is also assessing the possibility of selling a number of approximately 15 percent of the current portfolio of performing 221(g)(4) mortgages. A sale is expected to occur in late fiscal year 1994."

Is that part of the sale you are talking about?

Mr. RETSINAS. Yes, it is. We initiated phase 1 of that sale last week.

Mr. WATT. Is there a possibility that what is happening here is you all are selling the lower end mortgages and ending up with this increase in limits with the fund positioned in higher end mortgages? Or am I just missing the point?

Mr. RETSINAS. Perhaps I could comment on that. I do not believe FHA is in the business to hold mortgages. We are an insurance fund. We ought to insure mortgages that can increase the access to homeownership for American families throughout this country. That is our business.

Being a large insurance fund, we do have occasion, of course, to hold mortgages and to hold properties. Any insurance fund has that as part of its modus operandi.

It is clear to me, however, that we need to make sure that we focus our attention on the insurance function, not on holding the mortgages or holding the properties. So, therefore, anything we can do to expedite their disposition in a way that is prudent and makes financial sense to the government, we ought to do, and that is the path we are embarked upon.

Mr. WATT. So when you sell a mortgage, then, that is really either in a performing or nonperforming situation, if you do it on prudent terms, that ought to improve the fund?

Mr. RETSINAS. Yes, it will. As a matter of fact, the early returns from that initial sale last week indicate that was the case.

Mr. WATT. What do you project—I know this is speculation to some extent—does it get easier for you to sell those mortgages when the interest rates go down——

Mr. RETSINAS. Congressman, it is never easy. I learned that in 1 year. When interest rates——

Mr. WATT. When interest rates go down, I would think it would be easier for you to sell those mortgages and the trend back in the opposite direction, I would think, would make it more difficult to sell those mortgages. Again, maybe I am missing the point.

Mr. RETSINAS. No, your insight is correct. Generally speaking, there are exceptions to every rule. Generally speaking, properties become more valuable when interest rates go down. But I can't predict with certainty what interest rates will be. I can predict, however, if we don't address the problem of the disposition of the mortgages we hold, the properties we hold, it will deter us from focusing on what we need to do, focusing on the servicing of our existing portfolio and insuring properties to increase homeownership in this country.

Mr. WATT. Has that sale itself reduced—I mean, what is the volume of what we are holding now?

Mr. RETSINAS. It is in the report. I have to look at the report.

Mr. CRAREN. $7.8 billion of multifamily and $3.8 billion of single-family is what they now hold.

Mr. WATT. What would you think, Mr. Retsinas, the current figures would be?

Mr. RETSINAS. I don't want to speculate. I will get the numbers for you.

Mr. WATT. Do you think they have gone down? Do you think those figures have gone down?

Mr. RETSINAS. I will give you the specific numbers, Congressman.

[The information referred to can be found in the appendix.]

Mr. PROCACCINI. Can I give you a little more information on that from our perspective?

I am with GAO, my name is Bob Procaccini. We are also concerned about this mortgage assignment issue. We are doing some work currently for the House oversight and investigations group on government operations, looking at the single-family notes and management of those notes in the program currently.

The concern to us is somewhat very similar to what the commissioner and Price Waterhouse have noted. But beyond that, we are also looking at this program in terms of its outcomes. This program represents—the MMI portion of it, anyway—loans that were in a default status which HUD assumed and which HUD is going to work out agreements with. Theoretically, a very favorable outcome for a loan that goes into the program would be to resume currency and come back on line as a performing loan.

And the thrust of the work we are doing for the subcommittee is trying to take a look at the rate of success of loans under that program, and how is it possible to increase that rate of success so we can get more of these loans to become performing.

Mr. WATT. You are defining success in that way and not in terms of sale of the loan, but getting it back into a performing status.

Mr. PROCACCINI. We are defining success basically as avoiding foreclosure on that loan.

Mr. WATT. Do we have any way of tracking after a sale whether people are pursuing that objective, Mr. Retsinas? The folks to whom you are selling these loans, is their definition of success consistent with the definition of success that is being adopted by GAO? Or——

Mr. RETSINAS. Not at this current time. Again, our purpose in selling loans as an insurance fund is because of the impact of those mortgages on our loan servicing activities and the great attention they demand. Again, we are in the business of insuring, not holding mortgages. We are in the business of increasing opportunities for homeownership.

Mr. WATT. I don't mean to set you all up at opposite ends of the spectrum on this issue, but it sounds to me like your objective is completely different from the objective I am hearing on this end. If your objective is to get rid of the loans that are either performing or nonperforming, get them out of your system, and they are investigating—they are defining success in terms of putting nonperforming loans back on a performing status, it seems to me there is some inconsistency of objectives there, and unless there is an effort to reconcile those things—go ahead.

Mr. RETSINAS. I don't think, Congressman, there is an inconsistency. I am just trying to be as candid as I can in terms of our motivation.

Let me elaborate if I could. If we had additional staff, additional resources, I might come to the conclusion that it would be more efficient for us to achieve the objectives of restoring these loans if we held them in portfolio.

The fact of the matter is, with the resource and staff shortages we face, we are unable to turn the necessary attention to them. So the sale on the one hand frees up resources to focus on our existing insured portfolio, and two, I think it is a more efficient way to deal with the them. So I don't think the objectives are inconsistent.

Mr. PROCACCINI. I don't think so either, Congressman. What I think I was referring to is, to us, the success is to make the loan current, avoid delinquency and foreclosure. If we come up with a performing loan it becomes much more saleable on the private market.

Mr. RETSINAS. Exactly.

Mr. WATT. So there is a short period of time where the two things—if you are selling nonperforming loans it may be inconsistent, but——

Mr. RETSINAS. Not to belabor it, but certainly there is more value to selling a performing loan.

Mr. WATT. Thank you very much, Mr. Chairman. I am sorry I took more time than allocated.

Chairman GONZALEZ. No, sir. Thank you. I appreciate very much your interest and your performance on the subcommittee.

It is very difficult for me, having witnessed from the beginning the founding of HUD, and having had exposure to both the old FHA Commissioner during whose terms never once was there a breath of scandal. It is most refreshing, Mr. Retsinas, to see, maybe you have been here only 1 year, but the basic element of honesty and forthrightness is very apparent and very much appreciated by me. Because when we haven't had it, and it was noticeable, I was excoriated. I was the first to denounce the encroachment of corruption in HUD, in 1981.

I was the first person to meet with then-appointed Secretary Pearce, and was the first one to meet him immediately after his confirmation by the Senate. I first met him in the case of one of the so-called bailouts we had in this subcommittee, and I have been involved in every one of them. He had been hired by Secretary Connolly, and he was designated one of the four attorneys they sent over to discuss with us the bailout package for Lockheed.

So I knew him. He came from the elite Wall Street law firms. His background was upper class, an affluent family, Long Island. I was most interested in meeting with him.

It was February 8, 1981, because we had just gotten from Mr. Stockman, in the only appearance he ever made before a nonbudgetary committee, to his regret it was our subcommittee, the so-called black book which had been leaked out by the time Mr. Reagan was sworn in on January 20. It indicating that 80 percent of their recommended cutbacks or extinction of programs would be in the area that the subcommittee had jurisdiction over.

My assumption of the chairmanship of the subcommittee coincided with the assumption of the Reagan regime. So I wanted to meet with Mr. Pearce, and he had indicated that. As soon as he was confirmed, instead of my going over to see him, he came over to see me in my little office here at that time. It was quite obvious that we were going to be in for a difficult time.

Because in answer to a question, I asked Mr. Pearce as to what his position was vis-a-vis OMB Director Stockman, and his answer was, no, no problem. I said, well, I am talking about the integrity of the programs that you will be charged with administering, if it comes down to who is going to be able to discuss with the President. And he said, there won't be any such thing because we are all committed to the President's economic recovery plan, known as ERP.

And so I figured we were, and Mr. Stockman's appearance before this subcommittee, of which the written record is extant, clearly revealed he had no knowledge of housing finance. I had had contact with him when he was a Member of the House from Michigan. We had a couple of encounters, but he was touted by the press, as it often does, as a genius and an expert in financing and whatnot.

It is rather ironic that in his appearance before us to explain, he pointed to the fact that he had the recommendations. First, as a general premise, we hold to the belief that the country has an inordinate sector of the economy for housing. Inordinate and exaggerated, it has to be cut back.

So when I saw what he had pointed out, for a reduction of FHA, I said, well, if we do what you want, I say that by July 1, the Secretary would have to send out an order that they wouldn't be able to commit one penny's worth of insurance. He said, I don't know why, there is $31 billion here.

At that point one of the aides tapped him on the shoulder and by then he realized we weren't talking with defense financing. I wasn't out to embarrass anybody, I just wanted to make sure we would not underestimate the force of the threat to programs that the Congress had established only after long and prolonged debate and argument, such as FHA.

Nevertheless, the rest is history. But it was obvious by May of that year, because one of the first mandates was to cut back, as George Romney did when he assumed the Secretaryship of HUD in 1972, 1973, under Mr. Nixon, across-the-board cut in personnel. One of the things Mr. Pearce did was to eliminate immediately the in-house appraisal.

They also, at the same time Mr. Reagan did, appointed a gentleman from Denver as his assistant or deputy. By May, I was receiving reports from the Dallas region to Pennsylvania raising questions as to why appraisers from Denver were coming to Texas and Pennsylvania on such things as FHA.

So we checked and found that that was the real goal of the Secretary assistant. I had taken the Secretary's pledge when we met. He said, here is a number, if you ever want to reach me directly. So I did, and I couldn't get him. I then went through the assistant, and the assistant couldn't get any reply. So then we had a period of time in which throughout other areas, we got these same reports.

Somehow or another, I don't know why, but the word must have gotten out over there, and all of a sudden I had a request to meet with this Secretary, named Wynn, from Denver. The last I heard of him he was Ambassador to Luxembourg at the height of the government operations looking into Mr. Pearce, who is still scot-free, even though everybody right underneath him has either been indicted or convicted or both.

So it was quite distasteful for me, because at the same time he disassembled one of the contracting associations that had been formed for the first time, known as the first and only national Hispanic housing something or other. And so they came to see me: Why, all of a sudden, they were being disbanded on the direct order of Mr. Pearce? Again, I couldn't make contact, so I said there was nothing I could do.

Anyway, it was sad when just a matter of 3 years later, and the advent of a new Member from Milwaukee caused by the death of Mr. Zablocki, who had been chairman of the Foreign Affairs Committee, a freshman, who had been on board 4 months, said, look, I have a problem. The *Milwaukee Journal* has had daily exposes about wrongdoing in the appraisal and the collusion of the private realtor appraisers and some FHA officials.

So we took the subcommittee to Milwaukee. We had an all-day hearing, but we had not been into the hearing over 3 hours before it was obvious that we had received testimony, and evidentiary material, showing culpability, criminal culpability. So as we had done before in other cases in committees I had belonged to such as Small Business, at that time what we would do, we would refer it to the Justice Department.

My recollection is there wasn't much of an inspector general. I think in fact the inspector general' office was improved as a result of these experiences.

So anyway, what happened was it led to the indictment and conviction of four individuals, two FHA officials out of the Chicago office and two local real estate dealers. Coincidental with that came the push for such things as various schemes to substitute for public housing, turnkey and what not, and also the demise of 235.

But then the appearance on the horizon under pressure, because of the ideological—the whole ideological spectrum, then as now, was privatization. What I have always said is I believe in the public ownership of the government. But there are those who believe that we ought to have the private ownership of the government.

What the government has assumed since the Depression or the 1930's is certain tasks and responsibilities in responding to the needs emerging from our society. It has therefore made a decision, or the Congress has as a national policymaking body. From the beginning of our country the creation of every single entity that made it possible for the country to grow, the Panama Canal and all, those were all government subsidized, one way or the other.

So the big question isn't, as it has been debated even to this day, about the rightfulness or the wrongfulness of government to do anything. The question is in behalf of HOME. That is the issue.

Well, we all know, as long as mankind has been around, that the poor and the weak are not going to get attention unless something else has happened. When I saw, for instance, the beginning, what it took the committee going to Milwaukee, and then 2 years later, in Flint, Michigan, had the same thing, there we didn't even have the goal. We just brought it to the attention of the inspector general, who inescapably, which then had it referred to the Justice Department, and there you had the same thing, two indictments and two convictions of officials of the Department.

So it was very disheartening. I have never had any pleasure out of seeing anything or any person go wrong. It is sad, it is tragic, unnecessary, whether it is Members of Congress or whether it is private or what have you. But the thing I see is the breath of fresh air and hope. I am not saying it just because you are here, but because the actions show that there is an honest acceptance, without recrimination. One of the most tawdry things I ever felt about President Reagan and even Bush later was that they never stopped flagellating Jimmy Carter as a cause of all troubles, from carbuncles to deficits. Always, even in departing they were still blaming Jimmy Carter.

Let's look at the consequences which I was going to find out if there are any statistics we have of the scandal of the Coinsurance Program. Now, that was done fairly recently, in the late 1980's. I think it was 1986, 1987. It was done because of the pressure from mortgage bankers, or at least a segment of them, and the ideological holders of the public office at the time in the name of privatization.

But I knew the moment they went to such things as mod rehab, that you are going to have scandal. Even in the section 312, in our area a very successful rehab program, when you translate it into local, and you can have the local development agency pick up on rehabilitating a home, and you have to hire somebody, not a government official.

If any one of you has ever had any work done, built a house or anything, you know what a struggle that is. So we went through the local period in which 312's biggest asset was that the local managers were honest and were able to minimize the fraud. So what is the continuing—if there is any way of ascertaining—the continuing cost of the coinsurance scandal, because it is cumulative?

Mr. RETSINAS. Yes, it is. I will make a brief comment and perhaps Mr. Craren has specific numbers.

In addition to the scandalous activity which you refer to, certainly a very significant cost of that was the continued liability of the Federal Government to this day.

In our audit, in looking at our multifamily insurance portfolio, the continued difficulties with coinsurance remains a major portion of the amount of funds we have had to set aside to cover losses. We are still disengaging from that debacle.

I think at a minimum, even though we are paying the price of that debacle, we should learn from it. One of the ways we have learned from it is in proposing new kinds of partnerships and arrangements. We need to be more careful about who our partners are.

For example, I believe that it is unlikely that the State and local housing agencies are going to walk away. They are going to be there for the long term. If we are careful who our partners are, what their capacity is, what their resources are, what their will is, I think we can find partners who will benefit and enhance our performance, not detract from it.

I don't know whether Mr. Craren has any specific numbers as it relates to the coinsurance share of the loan loss.

Mr. CRAREN. I don't have specifics, but it was over $1 billion and the most surprising part of it was when mortgages were ultimately assigned to HUD, underlying properties sometimes were worth 20 to 30 cents on the dollar, so coinsurance was a huge loss.

Chairman GONZALEZ. Absolutely. See these values—for instance, in my area, I have been aghast when they came out here with Garn-St Germain. I was the only one that went to the Rules Committee to try to talk them down.

They had regulatory accounting standards and nobody could answer that question so I wasn't about to—but that was concocted in a summit conference.

It was just our chairman, Mr. St Germain, and Senator Garn, and the reason I was aghast was because when I finally got a copy of what they had, which was just on the eve of their going to the Rules Committee and thanks to the then-chairman of the Rules Committee, Mr. Pepper, I saw that 90 percent of that was in areas that we had never had any hearings on, 2 percent equity kicker, and it was all done in the name of saving the S&Ls. But in reality, it was the largest wholescale revision of the fundamental 1935 Banking Act since 1935.

It homogenized all the financial activities, credit unions, everybody else. They were all banks now. So it wasn't long after that—it had other things that I felt were inimical to the basic structural foundation of the thrifts or S&Ls.

Anyway, it wasn't long when we went into this agitated market and all of the contraptions they thought of such as GPMs. Graduated mortgage payments, they called them back home right away, GPMs because of the intricacy of the financing, by the time it went through the New York processes back home, they were GPMs.

I got that from back home and it wasn't a year before I started getting evidence of land flips, and I couldn't get anybody on the committee, the chairman or anybody else interested or the then-chairman of the subcommittee, so I went to the House floor.

It is all in the records. I annotated where we had a businessman asking me, "I thought this used to be against the law. I thought they used to put you in the pen." I said, "For what?" He said, "there are three guys that are organizing an S&L State charter."

He said "Others have already been formed. They asked me if I wanted to come in. I said I have no money. They said no, but you have 3,000 acres on the north side. They said that all you have to do is just put that up."

He said "Henry, I paid less than $800 an acre, but when I got scared was when they said they would put them down at $20,000 an acre."

So I said "Well, why are you calling me? You are an experienced businessman. You asked the question." I said, "I can't answer it because it may be legitimate."

Then the next case brought to my attention was all of this undeveloped land where this fellow went in and just blazed a little trail. They put it in the books of the S&L as developed land. Therefore, when the day of reckoning came, as it had to, the 1986 Tax, so-called technical corrections Tax bill, did away with a lot of these tax giveaways and so immediately between December 1986 and the first quarter, March 15, 1987, real estate values had gone down 42 percent in my area.

Now, where did that all go? Well, later, I reported to the mayor—they didn't want to accept it—that 3 years in a row, San Antonio had lost $1 billion of value of real estate. Where did it go? The way I put it was if somebody had gone there and set a torch to 23 percent, it would be the same thing. But we have gone through this before.

In fact, it seems that after wars, you have this—after the Civil War, you had the scandals of the 1869s, Jim Fisk, and the others, and they did the same thing that Mr. Keating did in our time and bankers are doing now except the day of reckoning hasn't hit them. But it is about to, and so when all of a sudden all of this value disappears, where did the money go?

Old Fisk said, well, it went where the woodbine twineth. In that day and time, you know they didn't have inside plumbing. They had the outhouses. And they would plant the woodbine because it gave a very perfumy flower in order to countereffect the odor. So what he was saying was that is where it went.

In this case, though, where did it go? Where are we now?

This is the reason why the statement on page 10 of Mr. Craren's testimony, it is important to provide some cautionary notes. First, the large portion of expected improvements in the MMI Fund's capital ratio depends on the ultimate performance of insurance written in 1992 and 1993.

Even though the current economic environment is more favorable to FHA, the performance of these books of business will become more certain only as actual default experience emerges.

Well, when do you think we could get some measurement of these default experiences?

Mr. CRAREN. Well, we found typically, Mr. Chairman, that the books season over a 5-to-7-year period, so we start to get meaningful statistics after the 2nd, 3rd, and 4th years. In that timeframe.

Mr. VENTO. Mr. Chairman, I think one of the phenomenons that occurred during this economic period that you are talking about in various areas were real estate values at least with regard to homes there was some volatility is that often the FHA Program works in a countercyclical manner.

So in the sense that it was restrained, it was not available to in essence play an historic role in this. Most of the models used, 6 or 7 years, that is history. Only the Russians or historians can change that. They are the most powerful people in the world, even more powerful than God. They can change history.

What the model uses is it takes a worst-case scenario and a positive scenario, all of which are lined up in the material, in the summary. They do model that.

Chairman GONZALEZ. I am sure that econometric models do the best they can, but even there you had some differences as explained by Ms. Bridgers in that to a certain extent you said there was a moderate difference between your model base and theirs.

The important thing here is, where are we now? Has this dried out? Now we had in the middle 1970's clear indication, you had the RIPT, the Real Estate Investment Trust scandals. I don't think there was any more needed evidence that we were—but you know if things seemed to be, for those who like us are relatively well off, we don't worry about it.

It is like the Vietnam war syndrome. As long as it was a poor kid across the tracks that was getting drafted, nobody gave much of a hoot, but I was reporting that 45 percent of those were going to get shot at in 1965. But later when the fatalities were coming in and they had a draw and they started touching on some of the upper middle class, then you began to get corporate chiefs calling the President saying "Hey," like the Senator from Georgia, "Get on or get out, but my son isn't going."

This is the same thing here. Now that the pressure is coming up, and downward, the masses of our lower middle class pushed to the poverty level now as the statistics reveal, we are beginning to see, but still haven't felt.

My big problem is, I think, pretty much addressed by the concern you expressed as to just what, and it has to be very, very excruciating to those that are trying to keep the congressional intent of the program alive. And that is another big issue.

But I wanted to end up by thanking Ms. Bridgers for her statement on page 5. Clearly, the legislative and other program changes have helped restore the fund's financial health and reversed the trend of the late 1980's and early 1990's toward insolvency.

I appreciate getting that recognition. We don't often get it, but I always recognize the bouquets.

Mr. VENTO. I know that your statement was sort of a summary statement in terms of trying to put this in perspective. One of the factors as we push the envelope in terms of amount of downpayment and loan-to-value ratio, Ms. Bridgers' testimony and others reflected a similar note of caution, is that as the private sector moves into a higher loan-to-value ratio, apparently there is discussion of that.

There is always hope that as they move in that direction, that increasingly the factors that are considered as to the risk assessment of the loan are not just the quantitative factors; that is, the downpayment, but increasingly moving into qualitative factors.

A more obvious one is housing counseling. If we counsel somebody, we can make a loan that would not otherwise be creditworthy.

In terms of audits and GAO and—I think Mr. Retsinas may be willing to use that factor more so than the auditors to your left. That is a concern.

If I am stating it incorrectly, I would be happy to be corrected by Price Waterhouse or by GAO. Increasingly that is where we are wandering. Some of this is common sense. As we push that envelope, I don't know whether or not that is going to happen that the FHA is going to lose its distinctiveness in having low downpayments and others will be offering the same thing, I don't think.

There is a big niche there and hope. We are always into demonstration and experimentation. It does, I think, reflect the need to, as the chairman had indicated, to have a better administrative capacity to be more responsive to the changes that are occurring, rather dramatic changes in the market.

One of the keys has been that just as for a long period of time age was a big factor in our economy, but housing has been one of the real pillars I think of a healthy economy of this country. So as far as is this a major component in that, along with other institutional entities, like Fannie and Freddie today in making the secondary market, I think it becomes imperative that so goes housing in a sense, so goes somewhat the health of the country.

The chairman raises questions about income levels, other types of financing mechanisms, other types of loans, equity type of loans. This is very much a concern and we can sit here and think up a lot of different factors for you to try and put into those models, but trying to find the key ones and those that make the difference is what is most important to the members as we try to make some decisions on this basis and make certain that in the end people can buy a home.

That is what we are after and we want to do it in a competent way. So far this fund has really performed. Most of us are pleased that the cloud has moved on and hope that lessons were learned.

Certainly, the laws have been changed. The question, obviously, that comes to mind is should that insurance that we collected, hopefully a lot of the refinancing, those are the same folks that were benefiting from that, benefited from it.

In the past, many of us were concerned that home buyers were going to have to carry the additional insurance for those that were in the portfolio already, that they are paying a premium not because of their risk, but because of risk in the portfolio. We are talking about changing or reducing some of the insurance. If that becomes possible at least making it a better judgment.

The question is the up-front premium. That is a question that should have been asked for 12 years and no one here can answer whether an up-front premium is better than collecting it on an annual basis. That is a fundamental issue and my instinct tells me that that doesn't help, that is a big problem in terms of loan-to-value ratio and a lot of other things.

I was arguing on financing more on closing costs, not less, keeping the low downpayment issue in place where they reduced up-front premiums and risk premiums. Are they adequate and do they work? Seems to me that there isn't a lot of options for some people that go FHA.

If we hammer them with higher up-front premiums, basically that is an overhead cost they shouldn't be paying. I get concerned about that in the sense that we are making homeownership less affordable and that becomes critical. We are involved quantitatively and qualitatively trying to deal with refining or redefining that.

I am pleased that we are moving in a deliberate manner with the information and I hope that that September report is not a shock wave on the—in the order of magnitude that ends up causing a lot of ruffling of feathers in terms of where we are going, so if there is new information, I hope we have it in a timely manner so we don't end up acting too hastily or imprudently.

Thank you, Mr. Chairman.

Chairman GONZALEZ. I want to join you and say try to keep us informed. That is the reason for this hearing. It has been very, very helpful to us. The break for July will enable the staffs to do so much technical drudgery that is never factored in by those that are not involved in it.

We have to have Legislative Counsel perfect in accordance with the proper statutory references and all the amendments that the committee agreed to, and together with the minority and majority staffs working together, we hope that we will have House action very quickly after we come back on, I think it is now, July 12.

So this is most helpful, and by no means an indication that if any new thought or information that you feel we should have should be withheld. We don't mean for this to be a terminal point. Actually, we can consider it the beginning of what we have to keep on going the rest of this session.

So I want to thank each and every one of you very much for your very great, very good, competent beyond any doubt, testimony and information given us. And to wish you a good—I don't know that you will get a break, the equivalent of the congressional break, but I worked over on that side longer than I have on this side so I can appreciate it.

But I am very grateful for your time and your patience. We have gone through the lunch period.

Thank you again very much and I wanted to thank the staffs, Ms. Nancy Libson, the staff director over here; and Mr. Joseph Ventrone and Vince Morelli who is with Mrs. Roukema on the subcommittee.

So thank you very much and we will stand adjourned until further call of the Chair.

[Whereupon, at 1:20 p.m., the hearing was adjourned.]

# APPENDIX

June 30, 1994

Hearing on the Actuarial Soundness
of the Federal Housing Administration's
Mutual Mortgage Insurance Fund

Opening Statement
Chairman Henry B. Gonzalez
Subcommittee on Housing and Community Development
June 30, 1994

Today the Subcommittee on Housing and Community Development will hear testimony as to the status of the FHA single family mortgage insurance fund as reflected in the two most recent studies conducted by Price Waterhouse for the Department of Housing and Urban Development. The Actuarial Review for Fiscal Year 1993 of the FHA Mutual Mortgage Insurance Fund was released on May 31, 1994 and the FHA's Audit of FY 1993 Financial Statements was issued on June 8, 1994. We will also hear from the General Accounting Office on its mandated actuarial analysis of the Fund.

From a preliminary review of these reports, it is clear that they recognize a substantial improvement in the solvency of the single family fund. It is my understanding that the capitol ratio through FY 1993 has reached 1.44%. and the projected capitol ratio for FY 2000 is 3.40% Obviously, the Fund has exceeded the 1.25% capitol ratio required to have been met by the end of FY 1992 as well as has exceeded the 2.0% ratio required to be met by FY 2000.

While I understand that the status of the fund is improving, the Congress is in the midst of passing legislation that will increase the authority of the FHA as it applies to the single family program which will have an impact on the Fund. I hope that today's testimony will address the anticipated effect of those initiatives on the future solvency of the MMI Fund.

On a different note, I hope that the testimony will also address my concern as to whether the FHA has the capacity to administer the initiatives as proposed in the housing reauthorization bill. The report on the financial statements recognizes four material weaknesses in the FHA. These weaknesses have been revealed in years past and yet have not been resolved. I am aware of the budget constraints and the staff shortages facing HUD; however, the future status of the fund depends on HUD resolving or mitigating these problems. I hope that the Congress receives a commitment from the Department to address these weaknesses before we move forward in expanding the FHA single family program.

With that, I want to thank the witnesses for appearing before the Subcommittee. I look forward to your testimony.

BOBBY L. RUSH
1ST DISTRICT
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CONGRESS OF THE UNITED STATES
HOUSE OF REPRESENTATIVES
WASHINGTON, D.C 20515

COMMITTEES
BANKING, FINANCE AND URBAN AFFAIRS
GOVERNMENT OPERATIONS

## OPENING STATEMENT FOR CONGRESSMAN BOBBY L. RUSH FOR HEARING BEFORE THE HOUSE BANKING, FINANCE AND URBAN AFFAIRS COMMITTEE REGARDING THE FEDERAL HOUSING ADMINISTRATION'S MORTGAGE MUTUAL MORTGAGE INSURANCE FUND (June 30, 1994)

Thank you, Mr. Chairman. Earlier this month, during our full committee markup of this Congress' housing bill, my fellow committee members and I spent a great deal of time discussing and agonizing over some substantial changes in the way that the FHA does business. All of these proposals, including my amendment to income target the FHA's operations, had some potential effect on the soundness of the FHA's Mutual Mortgage Insurance Fund. It remains to be seen what the effect of those provisions in this year's bill will have, especially in light of the fact that the changes that we have included in the bill were not taken into account in any of the analyses that we will discuss this morning. While I am heartened by some of the projections which our witnesses will report to us today, I am still very concerned about the distance that the FHA has to travel before it is possible to say that it is a well-managed arm of HUD. I am concerned about the high default rates on FHA loans, in particular in my district but also in many other areas of the country, and the effect that these continued defaults will have not only on the MMI fund but on the communities in which those defaulted properties sit and rot. And I am concerned about the distance that the FHA must travel before it can be legitimately said that the it is fulfilling its original mission of helping low- and moderate- income Americans to achieve the American dream of homeownership. Thank you.

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STATEMENT OF

NICOLAS P. RETSINAS

ASSISTANT SECRETARY FOR HOUSING-
FEDERAL HOUSING COMMISSIONER
U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

On the Actuarial Review
for Fiscal Year 1993
of the
Federal Housing Administration's
Mutual Mortgage Insurance Fund

Before The
SUBCOMMITTEE ON HOUSING AND COMMUNITY DEVELOPMENT
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
U.S. HOUSE OF REPRESENTATIVES

June 30, 1994

## Introduction

I would first like to thank the distinguished Chairman, Mr. Gonzalez, and Members of this Subcommittee for giving me this opportunity to come before you today to report on the results of an independent actuarial analysis of the economic value and soundness of the Federal Housing Administration's Mutual Mortgage Insurance (MMI) Fund.

The requirement for an independent actuarial analysis of the Fund is set forth in the Cranston-Gonzalez National Affordable Housing Act (NAHA).

### Factors Contributing to Positive Trends

There are six principal causes of the increase in the capital position of the Fund:

1. **A favorable interest rate environment**, combined with efforts to make FHA programs more customer-friendly, resulted in the second highest level of endorsements in history ($65.165 billion) in fiscal year 1993.

2. **A positive economic environment.** The number of claims paid declined due to more favorable economic conditions.

3. **Major modifications in management policies** that focus FHA resources on market demand and customer service.

4. **Changes in the FHA's refund policy** that are now consistent with the risk curve specified in previous actuarial studies.

5. **Increase in the level of prepayments.** Prepayments, specifically those prepaying out of the Fund, had the largest effect on the Fund's improved status, increasing the estimated fiscal year 1993 economic value by $1.201 billion.

   These unexpectedly high prepayments, which are due to lower interest rates, dramatically increased the estimated economic value, because the Fund avoids paying claims in the future on loans that prepay, paying only a small refund of the upfront premiums. Given that many of these mortgages were high-risk loans that entered the fund during the mid-to-late 1980s, the claims avoided were substantial

6. **Economic forecast**. The forecast for the economy is currently more favorable with regard to claims than last year's forecast, resulting in an additional $869 million of estimated economic value.

## Actions to Ensure Continued Soundness

We know our work is not over. We take very seriously the need to continue and improve financial management of the FHA's single family program to ensure its soundness. Our agenda includes:

-- **Continued aggressive monitoring** of the portfolio and mortgagees who participate in the Direct Endorsement Program and as servicers of the loans that FHA ensures.

- **More effective default monitoring** mechanisms and improvements in the management of our portfolios.

- **Technological enhancements**, such as electronic data interchange, to make HUD's processing more efficient, while improving the quality and timeliness of the data on the condition of the portfolio.

- **Administrative and program improvements** to attract mortgagors over the full spectrum of risk.

Illustrative of this latter point is HUD's legislative proposal to raise the maximum limit for high cost areas from $151,725 to 85 percent of the Fannie Mae/Freddie Mac limit (calculated to be about $172,675 based on present figures).

Price Waterhouse has provided information on FHA which shows that larger loan sizes have low claim rates. Raising the ceiling will also allow HUD to meet the credit needs of low- and moderate-income Americans who currently are not well served by the private market.

We hope that the soundness of FHA's Mutual Mortgage Insurance Fund encourages the Congress to adopt the single family proposals contained in HUD's Housing Choice and Community Investment Act of 1994.

**New Program Initiatives**

While financial soundness is a major goal of our FHA agenda, I am deeply concerned that FHA's single family program has suffered serious market decline over the past decade.

I am particularly alarmed at a recent General Accounting Office report which shows that the percentage of FHA's borrowers to all home buyers declined from a high of 30.7 percent in 1976 to only 23.8 percent in 1991. The study also shows that FHA's percentage of originations in urban neighborhoods declined from a high of 58 percent in 1979 to 41 percent in fiscal year 1991.

**Housing Choice and Community Investment Act**

In response to this concern, Secretary Cisneros transmitted the "Housing Choice and Community Investment Act of 1994" to the Congress on April 26, 1994. The Act contained a number of initiatives designed to revitalize and streamline FHA and provide wider opportunities for homeownership. The initiatives included:

-- **A new mortgage insurance program** for revitalization areas. Under the program, FHA would provide 100 percent financing to modest income, first-time home buyers in revitalization areas.

-- **An increase in the FHA mortgage limits**, tying them to an index. The increases would allow the Department to better serve a broad range of home buyers, including buyers in relatively high cost areas, who could not purchase a home because of downpayment requirements.

-- **A demonstration program** which would authorize FHA to insure a variety of alternative mortgage instruments as well as authorize FHA to enter into risk sharing arrangements with GSE's, State and local agencies, and other entities in order to provide affordable housing.

-- **A single family risk sharing program** with State and local housing finance agencies. Under the program, FHA would risk share with State and local agencies operating insurance programs.

-- **Broader housing and homeownership counseling** authority designed to increase the success rate of families seeking homeownership.

-- **A specialized refinancing program and a non-judicial foreclosure process** for assigned mortgages in the management and servicing area.

As Secretary Cisneros has stated, the overall program was created to "make HUD's Federal Housing Administration a positive force for enhancing homeownership . . . . and give FHA the authority to innovate."

In addition, the Department is considering the following changes which would be useful to FHA:

-- **Authorization for delegation of endorsement processing** to certain approved lenders in the direct endorsement program to relieve existing backlogs in FHA.

-- **Simplification of the calculation of maximum insurable mortgage amounts** to facilitate underwriting.

-- **Extension of the Home Equity Conversion Mortgage (HECM) demonstrations** to expand FHA's assistance to elderly home owners with modest incomes so they may remain in their homes through the use of reverse mortgages.

## Conclusion

The Federal Housing Administration has served as the cornerstone of America's housing market. There have been setbacks, such as the financial challenges of the 1980s and that is a valuable lesson to us all. But today, I am pleased that FHA's basic single family program is financially sound and is projected to continue to be sound.

With this comfort, we can turn our immediate attention to our customers and our prospective customers and seek ways of making FHA more affordable, more accessible to all Americans, particularly low- and moderate-income and central city families who without FHA would not be able to achieve the American dream of home ownership.

I see FHA's greatest potential being its ability to leverage other capital for public purposes--primarily through partnerships. With this in mind, I have been asked by the Secretary to conduct a six-month study of FHA's structure and capacity to form these partnerships.

The study will include a series of six forums around the country to discuss the future of FHA. These forums will bring together HUD and its employees and union representatives with residents, housing advocates, housing providers, builders, realtors, mortgage bankers, the secondary market as well as state and local governments to talk about FHA's organizational structure, and how it either helps or hinders partnerships.

The forums will begin in late July and run through early August. Tentatively, we have scheduled these meetings for Detroit, Charlotte, Denver, San Jose, New York City and Washington, DC.

These discussions will help us remove bureaucratic barriers that limit the effectiveness of FHA. Ultimately, we want to transform FHA to meet America's housing needs in the 1990s and beyond, while ensuring that the MMI Fund remains adequately capitalized.

Near the end of the calendar year, I will then make recommendations to Secretary Cisneros based on these conversations.

It is possible that the recommendations may form the basis for a new federal charter for FHA, a charter that will reaffirm its mission and recast FHA's structure, powers, and authority.

Our goal is to ensure that, when the transformation is complete, FHA will be a first-class institution with the same tools used by the best-managed businesses and other comparable organizations. FHA will then be in a position to fulfill its mission to expand housing choice and support communities by helping create partnerships that develop and preserve affordable housing. FHA will once again become a positive force for increasing homeownership and affordable housing opportunities for all Americans.

| | Current Year | Projected FY 2000 |
|---|---|---|
| FY 89 | 1.19% | |
| FY 90 | -.88% | 1.12% |
| FY 91 | -.04% | 2.19% |
| FY 92 | .43% | 2.44% |
| FY 93 | 1.44% | 3.40% |

From Chairman Henry B. Gonzalez
Question for
Assistant Secretary Nicolas Retsinas
Hearing on the Actuarial Soundness of the FHA MMI Fund
June 30, 1994

In your own words, please explain how the single family risk sharing program as proposed by the Department and as amended by the Committee will expand housing opportunities in high cost areas, and exactly how the program will be implemented at the State and local levels.

Assistant Secretary Retsinas' response to
**QUESTION FROM CHAIRMAN GONZALEZ**
**Hearing on Actuarial Soundness of the FHA MMI Fund**
**June 30, 1994**

**Q. In your own words, please explain how the single family risk sharing program as proposed by the Department and amended by the Committee will expand housing opportunities in high cost areas and exactly how the program will be implemented at the State and local level.**

A. Originally, the Department proposed two risk sharing initiatives. One was broad authority for a demonstration program to share risk with various housing providers, including State and local agencies and GSE's; the other was a specific program for risk sharing with State and local agencies operating (or which could operate) insurance programs for affordable housing. H.R. 3838 contains the latter proposal, but with certain amendments which will undermine its effectiveness.

The Department's proposal for single family risk sharing with State and local agencies was designed to do two things. First, the program addressed the needs of homebuyers in relatively high cost areas by coupling the FHA program with the State or local program which served these buyers. The prospective buyers would have the advantage of FHA downpayment terms, unless State requirements were stricter, and the State would have the advantage of credit enhancement, therefore making its program marketable on the secondary market.

Second, the program was proposed as a demonstration of the effectiveness of forging partnerships with other housing providers. The terms of the program limited FHA exposure by mandating that the State take the top portion of the loss up to a set amount; but, by the same token, State insurance reserves could be stretched farther, and more people could be served under the State program, because of the FHA involvement. In addition, the program could be operated by the State agency, for example, so that the Department could take advantage of their delivery system, including functions relating to loan servicing and property disposition. This is a desirable approach, given the constraints on HUD resources.

Under the proposal, HUD would be authorized to do business with a State or local agency which could demonstrate that it had the legal and financial capacity to operate a sound mortgage insurance program. Agreements would be negotiated with each prospective partner, establishing the risk assumed by each agency and the premiums to be shared. In addition, the State or local agency would agree to assume processing functions, including loan management and property disposition, and would have to use underwriting standards at least as stringent as those of FHA. These underwriting standards would be subject to HUD approval, and HUD could negotiate changes to the standards prior to approving an agency for participation in the program.

FHA could insure up to its maximum loan limit (but not in excess of 80% of value of the property) and the State, for example, would assume the risk on the rest of the obligation. In the case of a default and foreclosure, the lender would file a claim with the State or local agency, and the agency would pay the claim. FHA would reimburse the State or local agency for the amount by which the claim exceeded the amount insured by the State or local agency.

H.R. 3838 amends the proposal and creates serious flaws in the approach. First, the bill limits the amount which the State <u>and</u> HUD can insure to 35% of the obligation. Because of the perceived risk of these loans, which are likely to have relatively high loan to value ratios, the secondary market will not be willing to "self-insure" the other 65% of the obligation unless they charge a substantial guaranty fee. These fees are likely to have a chilling effect on the program and preclude partnership demonstrations. It is very unlikely that any entity would expend the resources to gear up for a program which would prove to be unmarketable.

Second, the House version of the program includes discretionary authority for the State or local agency to lay off their share of the risk on a private mortgage insurer. The discretionary nature of the provision means that this could be done without HUD review. This has destructive effects on the process of establishing risk sharing agreements (the agreement must include a firm delineation of the actual risk assumed by each party), and does not fit the claims process, where HUD is to reimburse the State or local entity under the current language. The current language makes no provision for a third party.

Because of the amendments, it is possible that the program could not be implemented if enacted in its current form.

Questions from Congresswoman Marge Roukema

Thursday, June 30, 1994

Hearing on the Actuarial Soundness of the Mutual Mortgage Insurance Fund (MMIF)

Questions for Mr. Retsinas, FHA Commissioner/Asst. Secretary for Housing

1. Congratulations, Mr. Commissioner, on meeting the Congressionally mandated capital ratio standard of 1.25%. I read with enthusiasm your News Release that cites the capital ratio standards for 1993 as evidence that the MMIF is actuarially sound. I would like to ask, however, based on your comments and testimony on July 27, 1993 before this Subcommittee on the same subject, whether we know the true picture of the MMIF. You stated on July 27, 1993, in part, and I quote:

> It is important to note, however, that the targets mandated by statute are the product of negotiations on reforms and are arbitrary to some extent, since no one can define with precision what constitutes a completely sound and healthy fund. They are simply one measure of soundness arrived at during a period of intense concern about credit management. (See Page 6 of Hearing Transcript, July 27, 1993.)

You also mention, during that July 27, 1993 hearing that you were concerned that heavy refinance activity may cause significant run-off of good/less risky loans from the FHA, and therefore create a mutual mortgage insurance fund of adverse selection.

a. Given last year's statement, do you feel that the capital ratio standards are arbitrary and do not establish, on its own, the complete picture of the actuarial soundness of the MMIF?

b. If you are consistent with last year's testimony, would you say that given the uncertainty in refinance activity, coupled with serious material weaknesses as identified in the IG/Price Waterhouse Audit, a more comprehensive picture of the actuarial soundness of the MMIF could be drawn?

c. To sum it up, we have a fund that met a capital ratio that you claimed was arbitrary, and we have compelling evidence to indicate that FHA suffers from a severe shortage of staff resources and administrative tools, including data management, in addition to uncertain assumptions noted in the Actuarial Study. Given that scenario, while being consistent your remarks last year, what is the actual true condition of the Mutual Mortgage Insurance Fund?

2. You are commended for being proactive and focusing on an internal six-month study of FHA's structure and capacity to form public/private partnerships. You state on page 8, of your written testimony, that the study will form a basis for recommendations that possibly create a new federal charter for FHA, which will reaffirm its mission and recast FHA's structure, powers, and authority.

a. While I think it is safe to say that all of us agree that FHA should be reviewed, your statement implies that you will be expecting significant changes to FHA, which may go beyond the mere reaffirmation of FHA public policy. Given your statement, what are you expecting, in terms of legislative recommendations and activity for this Subcommittee in six months?

b. You mention that the public forums, which are a part of this study, will "help us [FHA] remove bureaucratic barriers that limit the effectiveness of FHA." What do you expect will be discovered? Will the removal of bureaucratic barriers, which sounds very similar to "regulatory relief", require consultation with the Subcommittee and legislative action? Or, on the alternative, are these barriers removed through administrative action?

c. Because you emphasize the study's objective to "reaffirm" FHA's mission, who will be making this determination of what to reaffirm? I think a broader questions is how do we know what to reaffirm when the debate over the past few months centers on the issue of FHA's public policy mission, intended population, and desired benefit to the American society?

3. You cite the FHA's achievement of exceeding the required capital ratio standard of 1.25%. In fact this year's capital ratio is calculated at 1.44%, exceeding the mandate. On the other hand, the MMIF's excess of revenues over expenses fell 96% from 292 million in FY 92 to only $12 million in FY 93.

a. Why did the MMIF's revenues over expenses fall significantly in one year?

b. What is the role and impact of foreclosures, as they relate to the MMIF during the last year? Why are foreclosure such a problem for FHA? How will FHA handle the increasing number of foreclosures that are bound to occur when its business is increased after the new housing bill is enacted?

4. The IG/Price Waterhouse states that there will be a study of loans in default that are held by FHA and says that "only when this study is complete will HUD be able to asses the long-term outlook for operations of the single family program." (Page 13 of Audit)

a. Please explain this statement.

b. How serious is the rapid increase in these defaulted loans?

c. What are these loans likely to be? When will the losses be realized.

5. The MMIF operations have a negative cash flow that increased from $-143 million in FY 92 to $-163 million in FY 93.

a. Please explain how the MMIF can show a balance statement "in the black" while the operations appear to have a negative cash flow?

b. What are the sources of funds to cover the operations of the MMIF, given the operation's revenue loss?

6. The IG/Price Waterhouse Audit indicates continued operational problems for FHA, including insufficient staffing and administrative resources, the need to place more emphasis on early warning and loss prevention, the need to resolve defaulted single-family FHA loans, and the need to improve automated systems.

a. Do you agree with the Audit that identified these deficiencies in the operation of FHA?

b. If so, what would you estimate as the necessary staff and resources needed today, right now, to manage effectively FHA's business?

c. As a follow-up, given the expansion of FHA, what resources will you need, in terms of raw numbers for employee increases and administrative sources to manage the expansion?

d. In all likelihood, what is HUD's intent in meeting your staffing and administrative needs to meet the FHA expansion as a competent business enterprise?

Assistant Secretary Retsinas' responses to
**QUESTIONS FROM CONGRESSWOMAN ROUKEMA**
Hearing on the Actuarial **Soundness of the FHA MMI Fund**
June 30, 1994

Q.1a. **Given last year's statement (that the targets mandated by the statute are the product of negotiations on reforms and are arbitrary to some extent), do you feel that the capital ratio standards are arbitrary and do not establish, on their own, the complete picture of the actuarial soundness of the MMIF?**

A.1a. Congress, or any other body that regulates financial institutions, such as the FDIC, the Federal Reserve, or State regulatory agencies, must balance the effects of higher capital ratios on financial leverage and public benefits against the increased risk associated with lower capital ratios. There is no such thing as an optimal capital ratio for all institutions in all circumstances. Instead, regulatory bodies attempt to identify the appropriate balance for each institution, given the risks to which it is exposed and the public benefits it provides.

When Congress decided in 1990 on capital ratios for FHA, it followed a deliberative process in which just such a weighting occurred. The ratios were derived after analysis of the condition of the MMIF--and they represent an informed choice. There could, of course, have been other measures chosen and any measure could reflect a different methodology or could simply be a slightly higher or slightly lower number. This is the point of last year's testimony.

The Department is satisfied both with the measures of capital requirements and that the Mutual Mortgage Insurance Fund is sound. Price Waterhouse attested to this in the actuarial review for FY 1993. The conclusion has been supported by GAO.

Q.1b. **If you are consistent with last year's testimony, would you say that given the uncertainty in refinance activity, coupled with serious material weaknesses as identified in the IG/Price Waterhouse Audit, a more comprehensive picture of the actuarial soundness of the MMIF could be drawn?**

A.1b. The Price Waterhouse review of the soundness of the MMIF was comprehensive and concluded that the fund was sound. They indicated that at the end of FY 1993 the MMIF achieved a capital ratio 1.44 percent, in excess of the statutory requirement. The General Accounting Office (GAO) confirmed the Price Waterhouse work. GAO estimated under its baseline estimate that the MMIF had a capital ratio of 1.83 percent at the end of FY 1993. The Price Waterhouse estimates of economic value and capital ratios reflect the best, objective estimates based upon economic data from an independent and respected source (DRI).

In conducting the actuarial review of the fund for FY 1993, Price Waterhouse examined the concerns about refinancing activity, and the impact of that activity on adverse selection, and found that the evidence indicated that refinancings contributed to the improvement in the financial condition of the fund. Under every reasonable scenario about the impact of adverse selection, the trend toward improvement was observed. Price Waterhouse found that:

- The MMIF will comfortably exceed the 2.0 percent capital ratio under all scenarios;
- The MMIF achieves the 1.25 percent capital ratio no later than FY 1994 in all but the most extremely negative scenarios.

To the extent that weaknesses noted in the audit of FHA exist, the actuarial review implicitly factors in their existence in the fund's performance. Although many of the weaknesses identified relate to multifamily mortgage insurance, and thus to the General Insurance Fund, there are clear weaknesses involving the single family programs which were identified in the audit and which FHA has been addressing. Partly as a result of this work and the work identified in the future, FHA received a clean opinion from its auditors for FY 1993.

Q.1c. **To sum it up, we have a fund that met a capital ratio that you said was arbitrary, and we have compelling evidence to indicate that FHA suffers from a severe shortage of staff resources and administrative tools, including data management, in addition to uncertain assumptions noted in the actuarial review. Given that scenario, while being consistent with your remarks last year, what is the actual true condition of the Mutual Mortgage Insurance Fund?**

A.1c. To sum it up, the Price Waterhouse Actuarial Review of the Mutual Mortgage Insurance Fund for FY 1993 found that at the end of FY 1993 the MMIF has a capital ratio of 1.44 percent and an economic value of $4.554 billion. The review further estimated that at the end of FY 2000 the MMIF would have a capital ratio of 3.40 percent and an economic value of $15.254 billion. The review included sensitivity analyses to provide additional information regarding the entire range of possible outcomes under differing circumstances. Under all scenarios, including the most pessimistic, the MMIF will comfortably exceed the statutory capital ratio requirement for FY 2000.

RESPONSE TO QUESTIONS

2(a) If I knew precisely what recommendations would result from this study and would be accepted by the Secretary, there would be no need for the study. The Secretary was not being disingenuous when he said that there was no preconceived conclusion.

However, both the Secretary and I do believe that FHA faces serious problems in: (1) addressing today's management weaknesses; and (2) becoming a partner that is capable of leveraging private capital to meet our nation's unmet housing needs. Addressing these problems may require significant changes, particularly changes that would give FHA more flexibility to react to changing market conditions and housing needs and to use its resources in cost-efficient ways. The purpose of the study is to determine what changes, if any, would help to address these problems.

At the end of this year, I will make recommendations to the Secretary, which may include legislative proposals. If the Secretary accepts those recommendations, he may chose to forward those proposals to the Subcommittee for your consideration next year.

2(b) Since I do not know what ideas will be generated from the forums, I cannot be sure whether resulting proposals will require legislation or if they will require only administrative action. In any case, however, HUD will consult with the Subcommittee about any proposals that result.

2(c) The eight forums on the Future of FHA provide an excellent opportunity to explore publicly the mission of FHA. At each forum, we will ask a wide array of HUD program participants and beneficiaries as well as industry representatives and housing advocates for their reaction to our working draft mission statement:

> To expand choice and support communities by helping partners to attract and retain capital for the development and preservation of affordable housing.

I look forward to learning from the reactions of forum participants. During the study, I also will seek the reaction of members of Congress. I expect, however, that the real debate will not be about the mission, but about how FHA should try to accomplish the mission. In any event, any recommendations requiring legislation will come to the Congress for consideration, at which time the underlying objectives may be subject to further hearings, review, and debate.

Q.3a. **The MMIF's net income fell from $292 million in FY 1992 to only $12 million in FY 1993. Why did the MMIF revenues over expenses fall significantly in one year.**

A.3a. The financial audit showed that during FY 1993 revenues increased $67 million while expenses increased $347 million. On the surface, the increase in expenses appears to be attributable to an increase in the cost of holding and selling properties owned by HUD. In fact, these expenses were the same in both FY 1992 and 1993.

The increase in expenses for FY 1993 is due to a prior year adjustment made by the auditors for FY 1992. The prior year adjustment reduced the property expense account by almost $300 million because the auditors determined that reserves established in the prior year were no longer necessary. Unfortunately, a reader without knowledge of the prior year adjustment would mistakenly assume a decline in the health of the fund, and this is not accurate.

In fact, the current audit shows an MMIF equity position of $1.2 billion.

Q.3b. **What is the role and impact of foreclosures as they relate to the MMIF during the last year? Why are foreclosures such a problem for FHA? How will FHA handle the increasing number of foreclosures that is bound to occur after the new housing bill is enacted?**

A.3b. When a mortgage company wishes to file a claim on a defaulted FHA loan, in most cases it will first foreclose and then convey title to the property to HUD in exchange for insurance benefits. Over 80% of FHA claims occur in this fashion.

The remaining claims occur when mortgages are assigned to HUD through the assignment program. Under this program, under certain conditions HUD agrees to take over the defaulted loan from the lender and provide a period of forbearance to the mortgagor. If this doesn't work out, HUD would then foreclose.

Generally, claims were proportionately lower last year; and, the rate of FHA loans on which foreclosures were initiated changed little from the fourth quarter of 1992 to the fourth quarter of 1993, at about .5%. Of course, FHA makes allowance for losses in its financial statements and incurs staff expense in terms of handling foreclosures where HUD forecloses.

Foreclosures are a problem because they are simply hard to process, demanding substantial staff time and coordination with other agencies. Backlogs in foreclosure processing have arisen, and to remedy this problem the Department has proposed, and the House and Senate reauthorization bills have included, a non-judicial single family foreclosure process which could streamline the process and save the Department (and the MMIF) money.

HUD believes that additional business generated from the increase in mortgage limits will be sound, and that new proposals such as the proposals for a non-judicial foreclosure process and for authority to streamline refinance assigned mortgages will actually help the Department in this area. In addition, as the IG/Price Waterhouse audit notes on page 18, HUD will consider alternatives to foreclosure, if the study of assigned mortgages supports such an approach, and is evaluating its pre-foreclosure sale demonstration to determine the prospect of expanding that program.

As you know, the House bill does not include the insurance program for revitalization areas, the only new initiative for which the HUD FY 1995 Budget Request requested credit subsidy. In effect, HUD does not believe the impact will be large.

Q.4a. **The IG/Price Waterhouse Audit states that there will be a study of loans in default that are held by FHA and says that "only when this study is complete will HUD be able to assess the long term outlook for operations in the single family program." Please explain this statement.**

A.4a. The statement refers to the Department's single family assignment program, authorized under Section 230 of the National Housing Act. Under the program, HUD may accept assignment of a defaulted loan from a lender if the loan is in default due to temporary circumstances beyond the mortgagor's control and there are reasonable prospects that the mortgagor can resume payments under the note at the end of 36 months. During the period of assistance, the mortgagor makes payments under a forbearance agreement.

Over the years, the Department's portfolio of assigned defaulted mortgages has grown considerably. This has presented a challenge to the Department's ability to manage such assets and has been a drain on limited staff resources.

The study referred to in the audit was undertaken by the Office of Policy Development and Research to assess the costs (and benefits) associated with loans in the assignment program and whether these costs are, on average, greater than those associated with conventional claims. The results of the study will be integrated into financial projections and also will allow the Department to consider changes to the program which would help to reduce costs, meet the purposes of the legislation in a more efficient way, and help resolve any material weaknesses.

**Q.4b.** **How serious is the rapid increase in these defaulted loans.**

**A.4b.** It is serious. HUD's portfolio of assigned single family mortgages has more than doubled during the last six years. As of June 30, 1994, HUD held 107,898 single family notes. This inventory will be reduced upon completion of the sale of 15,211 notes which was held on June 29, 1994.

The cost of servicing these loans and the staff time devoted to this activity is expensive. Until the study of assigned mortgages is complete, the true cost of managing this type of portfolio is unclear. It should be noted that the bulk of the single family notes sold at auction were not the assigned defaulted notes from the assignment program, which demand the most work, but were current notes assigned to the Department pursuant to Section 221(g)(4) of the National Housing Act, a special provision allowing assignments of performing, current mortgages after 20 years.

Therefore, the Department has planned for other actions, in addition to note sales, for improving the servicing of the portfolio. These include improved portfolio and lender monitoring, technological improvements, and the HUD legislative proposal to allow streamlined refinancing of assigned mortgages. The audit report describes some of these activities on pages 17-18.

**Q.4c.** **What are these loans likely to be? When are losses realized?**

**A.4c.** There are about 12,000 single family assignments a year and most of the loans are in arrears for several months at the time of assignment. Allowances for losses on assigned mortgages are made on the financial statements, depending on the status of the loan--that is, whether it is performing or non-performing. Actual losses are realized after the mortgage has been foreclosed by HUD.

Q.5a. The MMIF operations have a negative cash flow that increased from -$143 million in FY 1992 to -$163 million in FY 1993. Please explain how the MMIF can show a balance sheet "in the black" while operations appear to have a negative cash flow?

A.5a. While the net cash used by operations increased by $20 million to $163 million, FHA is authorized to and has used interest income earned to offset operating costs. Cash provided by investing activities increased by over $550 million in FY 1993 resulting in an overall increase in cash of over $475 million.

Q.5b. What are the sources of funds to cover the operations of the MMIF, given the operation's revenue loss?

A.5b. In FY 1993, revenues exceeded expenses for the MMIF. The sources of income to the MMIF include: up-front and annual premium income; interest income from investments in Treasury securities; interest income from loans; and miscellaneous fees.

Q.6a. The IG/Price Waterhouse Audit indicates continued operational problems for FHA including insufficient staffing and administrative resources, the need to place more emphasis upon early warning and loss prevention, the need to resolve defaulted single family loans, and the need to improve automated systems. Do you agree that the audit identified these deficiencies in the operation of FHA?

A.6a. Yes. The audit was constructive in identifying areas where improvement in FHA single family operations was needed. As you know, FHA has been working for some time to address each area of weakness, and these efforts are described in the audit on pages 13, 17, 23 and 26. Because of the work HUD has done and has planned, FHA received a clean opinion from its auditors for FY 1993.

Q.6b/c. What would you estimate as the necessary staff and resources needed today, right now, to manage FHA business effectively? Given the expansion of FHA, what resources will you need, in terms of raw numbers of employee increases and administrative resources, to manage the expansion?

A.6b/c. The HUD Budget Request for FY 1995 contains the estimated resources needed to manage FHA now and in the future. The request included:

Field Staff: 5,375 FTE
Headquarters Staff: 965 FTE
Travel: $3.826 million
S&E Contracts: $3.140 million

In addition, FHA is assessing more efficient ways of operating so that currently planned programs can be accommodated by the requested resources.

**Q.6d. In all likelihood, what is HUD's intent in meeting your staffing and administrative needs to meet the FHA expansion as a competent business enterprise.**

A.6d. As indicated by the answer question #2, the Department is pursuing a focused effort to identify ways in which the FHA structure and delivery system can be improved so that it can fulfill its mission as a modern, competent organization. The results of this inquiry, which include forums around the country, will be reported by the end of the year.

FROM CONGRESSMAN BOBBY L. RUSH

**QUESTIONS FOR NICHOLAS RETSINAS, ASSISTANT SECRETARY FOR HOUSING - FHA COMMISSIONER, HUD:**

1. Has the FHA, or any other body to your knowledge, ever done a detailed analysis of the effect which income targeting would have on the soundness of the MMI fund?

2. While I understand that the maximum high cost FHA limit has been raised several times in the past four to five years, does the FHA have enough experience with these loans to predict how the new increase which this committee included in this year's bill can be expected to affect the long term stability of the fund?

3. According to information that I have received from the National Training and Information Center, Chicago leads the nation in level of FHA mortgage defaults. During the period between January of 1986 and October of 1991, there were nearly 6500 defaults and almost 2200 foreclosures in the Chicago metropolitan statistical area, at a cost to taxpayers of over $350 million Unfortunately, a large proportion of these bad loans were on properties in my congressional district. In fact, in one neighborhood, West Englewood, well over 20% of the loans went bad. While I understand that the FHA does not originate these loans, what has been done and what can be done to improve, for example, the performance of one mortgage company which had a more than 50% failure rate for FHA loans in West Englewood?

Assistant Secretary Retsinas' responses to

**QUESTIONS FROM CONGRESSMAN BOBBY L. RUSH**
**Hearing on Actuarial Soundness of the FHA MMI Fund**
**June 30, 1994**

**Q.1. Has the FHA, or any other body to your knowledge, ever done a detailed analysis of the effect which income targeting would have on the soundness of the MMI fund?**

A.1. I know of no such detailed analysis. However, if the market for FHA is compressed by income limits, it will narrow the range of buyers FHA can serve and over time lower the average and median income level of those served. This in all likelihood will adversely affect the performance of the fund and diminish its capacity to cross subsidize low and moderate income buyers and other underserved buyers. The current statute mandates that FHA be actuarially sound, and the statutory intent is to have FHA serve a range of buyers under a mutual insurance fund structure.

**Q.2. While I understand that the maximum high cost FHA limit has been raised several times in the past four to five years, does the FHA have enough experience with these loans to predict how the new increase which this committee included in this year's bill can be expected to affect the long term stability of the fund.**

A.2. Yes. As you know from the FY 1993 Actuarial Review of the Mutual Mortgage Insurance Fund, FHA's experience has been that historically larger loans have performed better than smaller loans. The attached chart indicates how the average cumulative claim rate for FHA loans decreases as loan size increases. This experience holds true for all books of business.

**Q.3. According to information I have received from the National Information and Training Center, Chicago leads the Nation in level of FHA mortgage defaults. During the period between January 1986 and October 1991, there were nearly 6500 defaults and almost 2200 foreclosures in the Chicago metropolitan statistical area, at a cost to the taxpayers of over $350 million. Unfortunately, a large proportion of these loans were in my Congressional District. In fact, in one neighborhood, West Englewood, well over 20% of the loans went bad. While I understand that the FHA does not originate these loans, what has been done and what can be done to improve, for example, the performance of one mortgage company which had more than 50% failure rate for FHA loans in West Englewood?**

A.3. The Department shares your concerns regarding high default rates and what can be done to improve performance. The Department's strategy involves, first, identifying mortgage companies with high failure rates; second, determining whether the problems are related to loan servicing or loan origination; third, reviewing the problem mortgagees; and, fourth, taking corrective action.

HUD is doing this through its newly instituted program of special reports designed to accurately pinpoint problems; these reports enable HUD to focus on the loan origination and servicing functions separately. Although a lender may both originate and service FHA-insured mortgages, HUD evaluates the lender's performance with respect to each function and targets each function for review separately.

The timing of the loan default can indicate whether the problem is with the underwriting or the servicing of the loan; this, in turn, enables HUD to target the originating or servicing lender. For example, first or second payment defaults almost always indicate poor compliance on the part of the originating lender. Indeed, underwriting is generally suspect for any default that occurs within the first 12 to 24 months of the life of the mortgage. A high level of defaults that occurring later in the term of the mortgage may indicate a servicing problem.

In all situations where we target lenders with default rates that are unusually high, HUD Headquarters requires a thorough on-site reviews to determine the cause of the situation and then requires appropriate corrective action to be taken. Additionally, Local HUD Offices are required perform a review of a percentage of loans originated in their jurisdictions to ensure the origination of quality loans.

Where HUD finds lenders in non-compliance to our servicing requirements, appropriate action is also taken against the mortgagee. The enforcement of HUD requirements occurs on several levels. Minor issues of non-compliance may be simply dealt with by requiring administrative action to correct the deficiency. Where non-compliance of a severe nature is found relating to the either the originating or servicing by the mortgagee, the mortgagee is referred to the Mortgagee Review Board where the sanctions against the mortgagee include assessments of Civil Money penalties, indemnifications and withdrawal of HUD's approval (to originate, hold and/or service HUD/FHA mortgages).

HUD will impose sanctions appropriate for the type of violation or non-compliance found. A sanction (such as revoking direct endorsement authority), that may be appropriate for an origination violation, is not appropriate to levy against a mortgagee who is in non-compliance with servicing requirements.

In addition to HUD's on-site monitoring of mortgagees, HUD will also begin monitoring the approval agreements with HUD/FHA-insured lenders in January 1995. This is important as any lender that cannot justify why their early payment default/claim rates are higher than 150% of the national average, will have their approval to originate HUD/FHA mortgages withdrawn.

With respect to the situation in Chicago, HUD determines the exposure to the MMI fund by reviewing the overall default rate for a jurisdiction, not just the early default rate or the default rate for one lenders' business for a certain period of time. At this time the Chicago Office jurisdiction has an overall default rate of 3.713% while the National average is 2.429%. (Ranking is 73 out of 80). Yes, Chicago does have a relatively high default ratio. However, their default ratio has remained relatively constant over the prior five years. (It has ranged from 3.614 % to 3.787%).

Chicago, along with Cleveland, Philadelphia, Newark and several other urban areas, share similar problems of aging infrastructure, declining property values, and unemployment. We aggressively monitor mortgagees with higher than average default rates servicing loans in these areas and look for bias in the servicing of these loans. However, what we have found primarily is that those areas have common economic problems such as a recent natural disaster or the closing of a factory that previously employed many of the homeowners in the area.

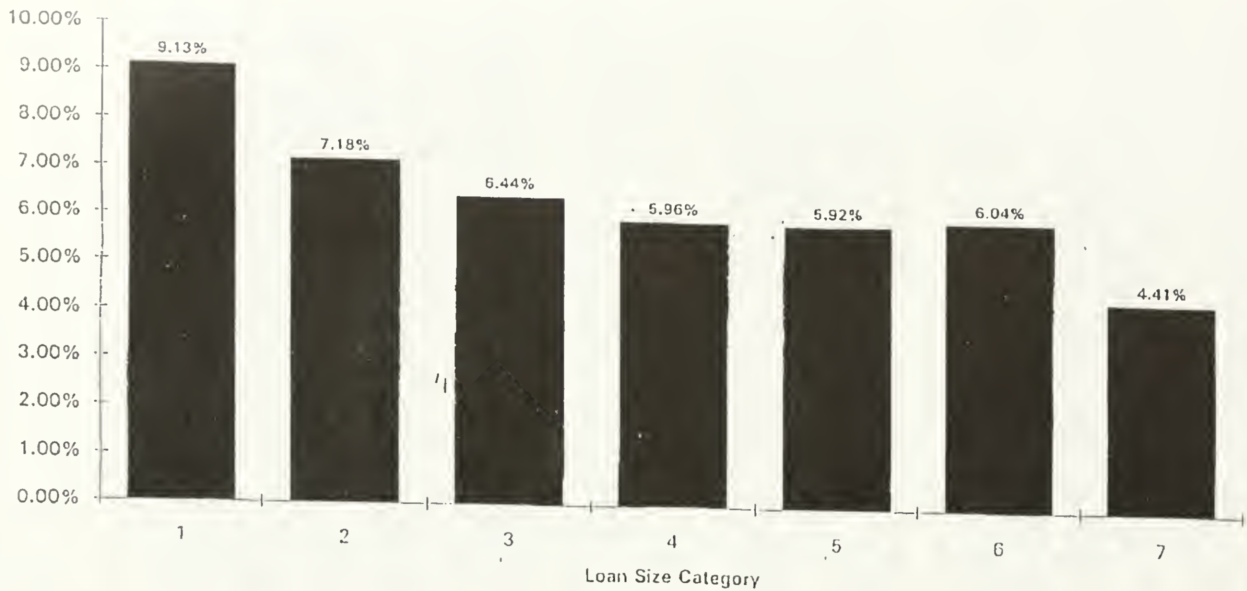
HUD has also increased the availability of both pre-purchase and default housing counseling to the West Englewood neighborhood that you expressed concern about. I believe this pro-active approach to assist those individuals who may be at risk in the area you indicated may yet yield improvements.

HUD cannot specifically respond to your issue concerning one lender's 50 percent failure rate of FHA loans in West Englewood without having more facts about the identity of the lender and the source for this data.

A 50 percent default rate for one lender's business would certainly appear excessive. However, under certain circumstances even a mortgage company that is doing everything correctly can experience unusually high default rates in a local market. For instance, if the mortgagee does very little business in a given neighborhood, a few loans going bad may constitute a high failure rate. Also, local economic downturns can increase defaults in concentrated areas for the best lenders. Generally, such circumstances, as regrettable as they may be, do not by themselves constitute a threat to the actuarial soundness of the MMI Fund.

**Attachment/Question 2: FHA Cumulative Claim Rate by Loan Size**

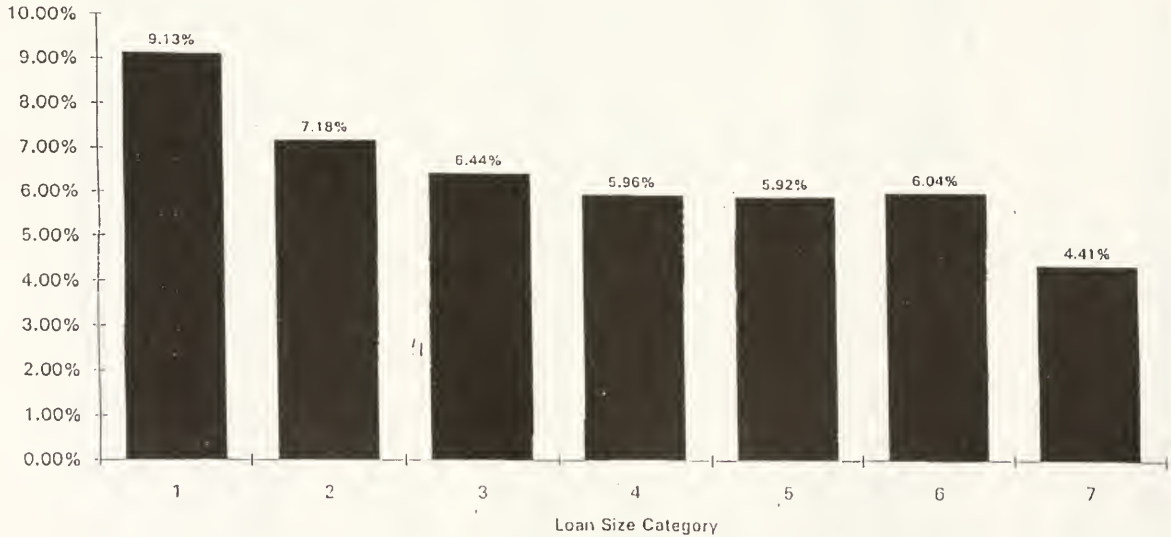
Average Cumulative Claim Rate in Policy Year 19 by Loan Size




For 1993, the Loan Size Category Upper Limits were: One - $46,778, Two - $56,489, Three - $65,489, Four - $74,846, Five - $84,201 Six - $102,913, Seven - $151,725

(Hon. Retsinas)

Average Cumulative Claim Rate in Policy Year 19 by Loan Size




For 1993, the Loan Size Category Upper Limits were: One - $46,778, Two - $56,489, Three - $65,489, Four - $74,846, Five - $84,201 Six - $102,913, Seven - $151,725

Hon. Nicolas P. Retsinas' Response to Colloquy with Congressman Watt re figures HUD holds regarding multifamily and single-family notes

As of June 30, 1994, HUD held 107,898 single family notes with an unpaid principal balance of $4,252,334,000. Those totals will be reduced by 15,211 loans and by $95,854,000 in unpaid principal balance when the June 29, 1994, sale of single family notes is registered on the books.

As of June 20, 1994, HUD held 2,355 multifamily notes with an unpaid principal balance of about $7.2 billion. Multifamily note sales are planned in the near future.

STATEMENT OF CHRIS GREER
ASSISTANT INSPECTOR GENERAL FOR AUDIT
DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

BEFORE THE U.S HOUSE OF REPRESENTATIVES
SUBCOMMITTEE ON HOUSING AND COMMUNITY DEVELOPMENT
OF THE
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

JUNE 30, 1994

Mr. Chairman, and Members of the Subcommittee, we are pleased to be here this morning to discuss the financial condition of the Federal Housing Administration (FHA), and, more specifically, its Single Family Programs. Our office issued the most recent financial statement audit of FHA on June 8, 1994. The audit covered FHA activities during Fiscal Year 1993.

Accompanying me today is Tom Craren, a partner in the Certified Public Accounting firm of Price Waterhouse. Tom has been personally involved in the financial audits of FHA since 1988. Price Waterhouse conducted the three most recent FHA financial statement audits, under contract with the Office of Inspector General, in accordance with the Chief Financial Officers Act of 1990. Our staff works closely with Tom and his staff in monitoring the completion of the audit and in providing input based on OIG audits of FHA programs and related issues.

Also with us this morning from Price Waterhouse is Barry Dennis. Barry and his staff conducted the actuarial analysis of the Mutual Mortgage Insurance Fund for Fiscal Year 1993, under contract with FHA. Mr. Craren relied on the actuarial review in performing his audit.

Mr. Craren has prepared a written statement concerning his work and will share that with you in a few moments. Before Tom begins, I would like to briefly provide some information relating to FHA Single Family Programs that was contained in our most recent Semiannual Report to the Congress for the period ended March 31, 1994.

Mr. Chairman, our office has testified often before this Subcommittee over the past few years. We appreciate the continuing oversight, because we believe it is a key ingredient in identifying potential programmatic or operational weaknesses and for holding HUD management accountable for correcting the problems and improving program performance.

Our Semiannual Report to the Congress assesses HUD's progress in addressing its ten most significant problem areas. We have been reporting to Congress on these issues since 1992. Three of these areas are systemic and affect almost everything that HUD does.

These systemic issues include HUD's Management Control Environment, Resource Management, and Data Systems. These weaknesses have a direct impact on seven programmatic areas, one of which is Single Family Housing Asset Management.

In Chapter one of our Semiannual Report, we point out that controls over HUD's multi-billion dollar Single Family Note Servicing and Property Management are inadequate, and comment on Assistant Secretary Retsinas' plans and actions to correct the problems. In short, we conclude that while there has been extensive analysis and strategic planning devoted to solving the problems, it is too soon to tell if the planned activities will, in fact, materialize and make a significant difference. Key efforts include changing staffing patterns and skills; finding alternative methods such as mortgage sales to reduce workloads; and modifying or reengineering current processes, such as assignments and property disposition. We believe that if the Office of Housing sustains its current momentum and focus, that many of the past asset management problems will be alleviated over time.

Our Office of Investigation continues to encounter significant numbers of criminal matters associated with FHA's Single Family Programs. During the 6-month period ended March 31, 1994, 49 cases were opened involving single family fraud. Actual results include 54 persons indicted and 59 persons convicted. Cash recoveries amounted to about $3.5 million. Our Office of Investigation currently is pursuing, either alone or in cooperation with the FBI or other Federal Inspectors General, 317 potential criminal cases involving Single Family Programs.

For the most part, the major criminal cases tend to be isolated instances of malfeasance by mortgagee personnel or brokers in the origination of loans, and by speculators/investors in strawbuying schemes. For example:

Sentences were handed out in Atlanta, Georgia, to five mortgagee loan personnel for their participation in a loan origination scheme in which false employment information was created and submitted in applications for over $1.3 million in FHA-insured loans. The cumulative sentences were 64 months in prison, 900 hours community service, 11 months home confinement, and nearly $577,000 in restitution.

In the area of strawbuying, a St Louis, Missouri speculator used 16 strawbuyers to obtain 28 FHA-insured loans totalling over $1.2 million. He was found guilty and sentenced to 4 years in prison and 2 years probation.

In summary, Mr. Chairman, our audit and investigative activities continue to point out assorted weaknesses in FHA's Single Family Programs. I would now ask that Mr. Craren provide you with more specific information about the financial condition of the FHA insurance funds. Thank you, and I will be happy to respond to any questions.

From Congresswoman Marge Roukema

Questions for HUD-IG (Chris Greer), Price Waterhouse

1. The bottom line in the discussions regarding the Actuarial Soundness of the MMIF is whether the estimations are correct. The IG/Price Waterhouse study indicates that the capital ratio is 1.44%.

a. What were the assumptions that allowed the IG and Price Waterhouse to come to this conclusion? I mean this in terms of economic climate, premium refund policy, and, refinancing activity. How do these factors, and others that we may not be aware of play into the determination of capital ratio standard of 1.44%?

b. If there were slight changes in your assumptions, such as the economic trend, etc., how would the capital ratio change?

2. There has been speculation by some experts that the Actuarial Study is highly speculative and cautious. I interpret that to mean that although there was a 1.44% determination, there were many aspects of the audit and study that caused Price Waterhouse to "hedge" its professional call. Could you comment on that concern?

a. As a follow-up, what were the effects of the substantial refinancing activity during FY 93? Are those refinances less or more risky than previous years? Is it possible that the riskier borrowers remained with FHA, and if so, was that taken into account in determining a 1.44% capital ratio?

b. What is the loan-to-value ratios on these refinanced FHA mortgages and what impact, positively or negatively, did this activity have on the MMIF in FY 93?

3. It appears that this debate over FHA's involvement really comes down to whether FHA is capable of absorbing an expansion of its program. In other words, whether FHA has the capacity to manage effectively its mortgage insurance business and the ancillary activities such as assignment, foreclosure, property maintenance, and property disposition.

a. What is FHA's capacity to manage effectively its mortgage insurance business?

b. Given the proposed expansion of FHA through increases in the FHA mortgage loan limit and the risk-sharing program, will FHA have the capacity to handle its expanded business?

4. Given the increases in the FHA mortgage loan limits to $101,575 in its base floor and as high as $172,678 in high-cost areas, what is the impact of the FHA expansion on the private sector entities?

a. In other words, will this expansion "cut" into the private mortgage insurance business? or, Will this expansion serve current underserved markets whose homeownership needs are not being met by the private sector?

b. If the FHA expansion will serve current underserved markets, then what are those markets? (minorities, inner-cities, first-time homebuyers, high l-t-v loans, etc.)

5. The Committee Print for the Housing and Community Development Act of 1994 includes a new program called the "FHA single family mortgage insurance risk-sharing program."

a. What is the impact of that new risk-sharing program on the MMIF? Will this program affect the capital ratio?

6. The 1990 housing bill (National Affordable Housing Act), among other things, required that the payment of distributive shares by FHA be based on the actuarial soundness of the entire MMIF and not solely on the performance of loans endorsed during a particular year of business. It also require other provisions intended to make the financial footing of the MMIF meet safety and soundness requirements.

a. In light of the IG/Price Waterhouse audit, do you think it prudent for FHA to begin paying distributive shares once again?

b. On a broader level, do you think that it would be prudent at this time to revisit the provisions of NAHA and, if so, what changes would you make regarding the current program's structure?

7. Price Waterhouse states that the entire MMI books of business from FY 75 through FY 93 are generating a negative cash value of -$6.5 billion. This means that future cash outflows from the Fund to cover claims and other costs associated with loans on the MMIF books is $6.5 billion more than cash inflows these loans will generate through premiums, recoveries and other income.

a. Given PW's statement, is it premature to argue that future FHA loans will "bail-out" the current loans?

b. In light of this large negative cash situation, is it premature to determine whether the single family is now on a solid financial (actuarial) foundation?

Responses from Chris Greer to
Congresswoman Roukema's Questions

Attached are Mr. Greer's comments on question numbers 3, 5 and 6.

The remaining questions relate specifically to the work performed by Price Waterhouse on the actuarial study of the Mutual Mortgage Insurance (MMI) Fund. While Price Waterhouse is under contract with the OIG to perform the annual audit of FHA, the MMI actuarial study is performed under a separate contract between FHA and Price Waterhouse. Note that OIG is not a party to the actuarial study contract, which is performed by Price Waterhouse's actuarial group and not the same individuals who perform the audit. Accordingly, HUD does not have a basis for commenting on question numbers 1, 2, 4 and 7. Price Waterhouse provided a direct response to these questions, and this response is also attached.

**HUD, Office of Inspector General**
**Comments on Selected Questions from**
**Congresswoman Roukema**

*3.a. What is FHA's capacity to manage effectively its mortgage insurance business?*

The HUD Office of Inspector General (OIG) is on record as believing that HUD generally does not have the capacity to effectively administer its programs as they are currently structured. HUD management agrees. Under the realization that a significant increase in resources is not likely in today's budget environment, HUD management has developed strategies for restructuring its programs, operations and workload to better pursue its mission within existing resource levels. FHA's general strategy is to foster new partnerships for housing production, and to sell off assets or streamline time consuming asset management activities to free up resources for greater loss mitigation efforts. OIG generally supports this strategy, but much remains to be done to effectively implement it.

To increase HUD's ability to improve FHA's capacity and management controls, the Congress needs to provide FHA with greater flexibility within its total salaries and expense budget. Full time equivalent staffing ceilings should be eliminated to enable FHA to make contracting-out decisions on the basis of cost-benefit and risk, versus current necessity. Separate authority to use non-appropriated FHA funds for long term automated systems improvement needs should also be granted, with the provision that detailed systems development plans and budgets be submitted to Congress as a vehicle for providing oversight and accountability.

*3.b. Given the proposed expansion of FHA through increases in the FHA mortgage loan limit and the risk-sharing program, will FHA have the capacity to handle its expanded business?*

In reviewing H.R. 3838, overall, we find the proposals in keeping with FHA's general strategy. In total, we believe the impact of these provisions should have a positive impact on FHA's operating capacity, freeing up resources to better concentrate on higher risk activities and projects to mitigate potential losses. However, the implementation of any significant new programs, such as Single Family Risk Sharing and the previously unfunded National Homeownership Trust Fund, could detract from FHA's ability to successfully complete the long needed management reforms in its core programs.

In a previous communication with the subcommittee dated July 19, 1994, we provided our assessment of the impact of seven key provisions of H.R. 3838, including increasing the FHA mortgage loan limit and the risk-sharing program. This assessment is presented on page 3. The individual impacts of these seven provisions on FHA's financial risk is difficult to assess. For example, there have been insufficient FHA data and analyses to anticipate with any certainty the impact of the proposed increase in the maximum single family mortgage insurance amount. However, GAO recently testified before your committee on the Veterans Administration's favorable experience with higher valued mortgages. FHA management believes a higher mortgage ceiling will benefit FHA, too.

Moreover, some of the provisions increase FHA's already extensive reliance on outside entities for program operations. Any increase in reliance on outside parties brings an inherent increase in risk to FHA. However, HUD's salaries and expense budget situation leaves FHA with little alternative, and the increased risks can be reduced with proper management controls to appropriately target and act on higher risk activities and projects with FHA's existing resources.

5.a. *What is the impact of that new risk-sharing program on the Mutual Mortgage Insurance Fund? Will this program affect the capital ratio?*

See response to number 3.a., above and the assessment presented on page 3.

**H.R. 3838**
**HUD/OIG Comments**
**Impact on FHA Program Capacity**

| Section | Title | Potential Impact on FHA | |
|---|---|---|---|
| | | Operating Capacity | Financial Risk |
| 403 | Maximum Mortgage Amount Floor for Single Family Mortgage Insurance | Expanding eligibility range has a minimal impact on capacity | FHA asserts decreased risk, VA experience is favorable, little data/analysis on FHA's 92 Act increase |
| 406 | Streamlined Refinancing for HUD-Held Mortgage | Removing notes from HUD's time consuming inventory will improve capacity | Resulting lower mortgage payments reduce risk of foreclosure and property disposition costs |
| 407 | Extension of Home Equity Conversion Mortgages Demonstration | Extension of this limited demo will have little capacity impact | Limited demo has little impact on FHA risk |
| 408 | Single Family Risk-Sharing Mortgage Insurance Program | Implementing new programs adversely impacts FHA's capacity, but SHFA's would retain property disposition | This new category of "high cost" housing business increases FHA's total risk |
| 409 | Delegation of Single Family Mortgage Insuring Authority to Direct Endorsement Mortgagees | Streamlining process will improve FHA's operating capacity and eliminate a current area of backlogs | This change increases FHA's risk and the need for more aggressive pursuit of HUD indemnification actions |
| 410 | Eligibility Of Mortgage on Homes on Leased Land Owned by Community Land Trust | Expanding eligibility criteria has a minimal adverse impact | Increased risk but limited activity |
| 152 | National Homeownership Trust Fund | Implementing this previously unfunded program adversely impacts Housing/FHA's capacity | Potential increase from higher risk owners with less of a stake in the property |

*6.a. In light of the IG/Price Waterhouse audit, do you think it prudent for FHA to begin paying distributive shares once again?*

Until the MMI Fund's capital ratio actually reaches the target of 2.0 established by the Cranston-Gonzalez National Affordable Housing Act, we do not believe it to be prudent for FHA to pay distributive shares. In fact, this Act could be interpreted to prohibit payment of distributive shares until that target is achieved (see Section 332 of this Act). As currently structured, the MMI fund is required by law to be self sustaining. The capital ratio requirement was established with the realization that a certain level of reserves is necessary to act as a "cushion" against the adverse consequences of an economic downturn in the housing markets.

*6.b. On a broader level, do you think that it would be prudent at this time to revisit the provisions of the National Affordable Housing Act and, if so, what changes would you make regarding the current program's structure?*

It is certainly within the prerogative of the Congress to periodically revisit the provisions and basic structure of FHA's MMI fund. We would caution, however, that if the Congress wishes to open the program to more individuals, it runs the risk of changing the basic characteristic of the fund from one that is self sustaining to one that will require annual credit subsidy appropriations. We question whether such a decision would be prudent in the current budget environment.

STATEMENT OF THOMAS J. CRAREN
PRICE WATERHOUSE

BEFORE THE
SUBCOMMITTEE ON HOUSING AND COMMUNITY DEVELOPMENT
OF THE
U.S. HOUSE OF REPRESENTATIVES
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

June 30, 1994

Mr. Chairman and members of the Committee, we are pleased to be before you today to discuss the results of our annual financial audit and of our actuarial review. Price Waterhouse recently completed both of these reviews and issued written reports on them, copies of which have been given to the committee. Under the CFO Act, FHA is required to prepare annual financial statements and subject them to an independent audit. This audit involves all of FHA's major activities, including its single-family mortgage insurance program, operated through the Mutual Mortgage Insurance (MMI) Fund, as well as FHA's multifamily mortgage insurance programs, operated predominantly through the General Insurance Fund. The audit we just completed was of FHA's financial statements for the fiscal year ended September 30, 1993. The annual independent actuarial review of the economic net worth and soundness of FHA's Mutual Mortgage Insurance Fund, which was also done as of September 30, 1993, is required by the Cranston-Gonzalez National Affordable Housing Act (NAHA). Accompanying me today is Barry Dennis, a partner in our finance and economics group, who directed the actuarial review. We appreciate the opportunity to provide this statement and answer any questions the committee might have.

The financial statement audit and the actuarial review present several relevant pieces of information about FHA's financial condition, its soundness and the status of its internal control structure. The remainder of our statement will discuss this information in more detail. Before doing that, it might be useful to provide a brief overview of FHA. The following table provides summary financial information for FHA's major activities:

| Federal Housing Administration<br>Summary Financial Information<br>Fiscal Year Ended September 30, 1993<br>(dollar in millions) | | |
|---|---|---|
| | MMI | GI & SRI |
| Insurance in Force (amortized) | $285,487 | $75,944 |
| Total Assets | $10,576 | $4,264 |
| Equity (Deficiency) Position | $1,175 | ($7,481) |
| Economic Value | $4,554 | N/A |
| Capital Ratio | 1.44% | N/A |

The table highlights the relative size of FHA's insurance activities, and its net equity or deficiency position determined in accordance with generally accepted accounting principles, which is analogous to a private company's net worth. With respect to the MMI Fund, its economic value is presented as well. Economic value, which pursuant to NAHA is the basis for determining MMI's capital ratio, is different from GAAP-determined net worth and is somewhat analogous to equity determined on the basis of a "mark-to-market" or "fair value" calculation. Some financial institutions present this or similar information with their traditional financial statements. Both are distinct and relevant measures of the MMI Fund's financial condition.

## ACTUARIAL REVIEW OF FHA'S MUTUAL MORTGAGE INSURANCE FUND

The primary purpose of our actuarial review was to estimate:

- The economic value of the MMI Fund, defined as the sum of existing capital resources plus the net present value of all future cash flows. The existing capital resources are resources the Fund currently has to cover the future liabilities of the total insurance-in-force. The net present value of future cash flows is the net of the present value of the future claims that will be paid less the present value of the future premiums that will be collected.

- The current and projected capital ratio, defined as the economic value divided by the total insurance-in-force. The capital ratio is a measure of the extent to which the Fund has or will develop resources in excess of what is required to cover any expected future claims. Insurance is a risky activity. Thus, even when resources are sufficient to cover expected claims, there is the risk that claims will exceed what is expected and that resources will therefore be insufficient. The capital ratio is a measure of the extent to which resources are available or will be developed that exceed what is needed to cover expected future cash flows.

**Status of the Fund**

In this year's Review, we estimate that the Fund had total capital resources of $9.698 billion as of the end of FY 1993, and a present value of future cash flows of -$5.144 billion (i.e. expected future premiums are $5.144 billion less than expected future claims). Thus, we estimate that the Fund had an economic value at the end of FY 1993 of $4.554 billion. In other words, we estimate that the Fund had resources at the end of FY 1993 that were $4.554

billion greater than needed to cover the expected future cash flows of the remaining books of business.

Given this estimated economic value at the end of FY 1993, and the estimated unamortized insurance-in-force of $316.527 billion, we estimate that the capital ratio was 1.44 percent. Similarly, we estimate that the capital ratio of the Fund will be 3.40 percent by the end of FY 2000. Thus, although we estimated last year that the Fund had not met the FY 1992 capital ratio target of 1.25 percent established by NAHA, we estimate that is has now passed the target in FY 1993. We also project that the Fund will exceed the FY 2000 target of 2.00 percent.

Our current projections indicate that the Fund's economic value will continue to increase in the future, rising by an average of 19 percent in each successive fiscal year until FY 2000. Exhibit 1 provides projections of the Fund's economic value, insurance-in-force, and capital ratios until the end of FY 2000.

**Exhibit 1: Projected MMI Fund Performance for FY 1993 to FY 2000**

**($ in Millions)**

| Fiscal Year | Economic Value of the Fund | Capital Ratio | Insurance in Force |
|---|---|---|---|
| 1993 | $4,554 | 1.44% | $316,527 |
| 1994 | $6,127 | 1.92% | $319,630 |
| 1995 | $7,198 | 2.09% | $344,318 |
| 1996 | $8,687 | 2.39% | $363,932 |
| 1997 | $10,235 | 2.67% | $383,966 |
| 1998 | $11,845 | 2.92% | $405,135 |
| 1999 | $13,518 | 3.17% | $426.643 |
| 2000 | $15,254 | 3.40% | $448,358 |

The estimates presented here require projections of events thirty years into the future. These projections are dependent upon a number of assumptions, including economic forecasts by DRI/McGraw-Hill and the assumption that FHA does not change its refund and premium policies. To the extent these assumptions, or others, are not accurate, the actual results will vary from our projections.

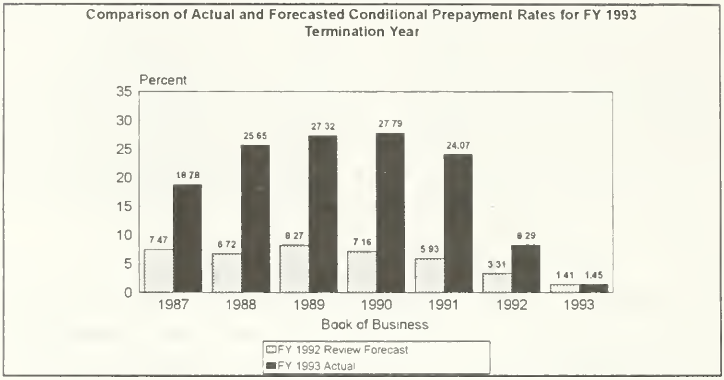
**Sources of Improvement in Status of the Fund**

The much improved current position of the Fund reflects an increase in estimated current economic value of $3.149 billion between the end of FY 1992 and the end of FY 1993. A total of $953 million of this increase was anticipated in last year's Review. The remaining

$2.196 billion increase is the net effect of unanticipated developments during FY 1993 and new economic forecasts ($2.654 billion), technical changes to the estimation models (-$0.932 billion), and changes in FHA refund and premium policies ($474 million).

The most important unanticipated development during FY 1993 was the tremendous level of prepayments, which occurred at four to five times the level anticipated last year (see Exhibit 2), increasing the estimated FY 1993 economic value by $1.201 billion.

Exhibit 2




In addition, the forecast for the economy is currently more favorable with regard to claims than last year's forecast, resulting in an additional $869 million of estimated economic value.

The significant increase in the forecast FY 2000 capital ratio from the FY 1992 Review estimate of 2.44 percent to the current estimate of 3.40 percent is the net effect of an increase of 1.79 percentage points due to the unanticipated 1993 events and a revised economic forecast, a decrease of 1.00 percentage points due to technical refinements to the estimation models, and an increase of 0.17 percentage points due to the changes in FHA refund and premium policies. The largest change (an increase of 1.55 percentage points) is due to the more favorable new economic forecast. This new economic forecast affected the forecast FY 2000 capital ratio primarily through revised projections of claims rather than prepayments.

**Impact of Economic Forecasts**

The economic value of the Fund and its pattern of capital accumulation to FY 2000 depends on several factors. One of the most important factors is the nation's future economy during the remaining lifetime of FHA's books of business. Interest rates affect initial and ongoing payment burdens on household cash flows, and hence default risks. Interest rates also affect the potential for prepayments due to refinancing as prevailing interest rates change during the lifetime of each book. Faster average house price growth facilitates the accumulation of home equity which tends to significantly reduce the likelihood of borrower default. It also contributes to greater mobility and household asset portfolio rebalancing, leading to greater turnover of housing and refinancings, thus increasing prepayment rates. Faster income growth reduces the burden of mortgage payments on household cash flows over time, reducing risks of default and claims as mortgages mature.

The base case results in this report are based on DRI's baseline forecasts as of May 1994 for interest rates, constant quality house prices, and inflation rates. We considered two other scenarios: (1) DRI's pessimistic forecast which projects lower real GDP growth and higher inflation and interest rates (referred to here as the "high inflation" scenario); and (2) DRI's optimistic forecast which projects higher real GDP growth and lower inflation and interest rates (referred to here as the "low inflation" scenario). We present our estimates of the Fund's performance under each of these economic scenarios in Exhibit 3.

Exhibit 3

| Summary of MMI Performance by Macroeconomic Scenario | | | |
|---|---|---|---|
| | High Inflation | Base Case | Low Inflation |
| Current Economic Value (FY 1993) | $5,690 million | $4,554 million | $4,239 million |
| Current Capital Ratio (FY 1993) | 1.80% | 1.44% | 1.34% |
| Projected Capital Ratio, (FY 2000) | 4.13% | 3.40% | 3.20% |

While the estimated economic value and capital ratios do vary with the macroeconomic scenarios, they change only moderately. In each case, the estimated capital ratio at the end of FY 1993 exceeds 1.25 percent and the projected capital ratio at the end of FY 2000 exceeds the NAHA mandated 2.00 percent.

**The Potential Effect of Adverse Selection**

Adverse selection occurs when the conditions of insurance (such as price, convenience and cash flow) results in the underwriting of higher-risk loans, while lower-risk loans select lower premiums elsewhere. Because of the dramatic interest rate decline in FY 1992 and FY 1993, FHA experienced an unusual number of prepayments, many of which left FHA. The MMI premium structure is generally more competitive with PMIs for higher-LTV (generally higher-risk) loans, and less competitive for lower-LTV (generally lower-risk) loans, providing a strong incentive for adverse selection. However, sufficient information is not yet available to either prove or disprove the existence of adverse selection with regard to the FY 1992 and FY 1993 prepayments.

We have examined the sensitivity of the FY 1993 Actuarial Review results to two potential effects of the large prepayments. First, we assessed the effect of the possibility that the unusually large prepayments left a higher mix of riskier loans in the existing books of business. Second, we assessed the effect of the possibility that the large refinancings experienced in FY 1992 and FY 1993 substantially lowered the risk profile of the refinanced loans. This lower-risk profile is likely since refinancing lowers the monthly payment burden, while leaving other characteristics unaffected.

In assessing the sensitivity of the results of the FY 1993 Actuarial Review to these effects, we have adjusted the projected conditional claim rates by selected amounts. We have little factual basis on which to select the magnitude of the adjustments. While we have selected adjustments that we believe to be plausible, the adjustments are meant to be primarily illustrative.

The results of our sensitivity analysis show that under all but the most extreme scenarios, the effect on estimated economic value and capital ratios is moderate. Under all scenarios, we project that the Fund will still comfortably exceed the FY 2000 NAHA-mandated capital ratio of 2.00 percent. In the extreme negative scenarios, the Fund would reach the 1.25 percent capital ratio in FY 1995 or 1996, and exceed the 2.00 percent capital ratio in FY 2000.

## FINANCIAL STATEMENT AUDIT

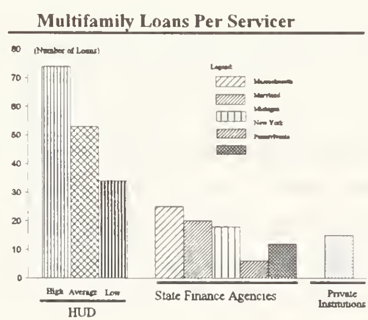
Perhaps the most significant initial observation from our 1993 financial statement audit is that it was the first time we were able to express an opinion on all of FHA's financial statements. Prior to 1993, we had to repeatedly disclaim providing an opinion on FHA's financial statements primarily because FHA did not have good or reliable information to allow it to quantify risk in its portfolio of insured multifamily loans, nor did it have sufficient control over the properties or loans it acquired as a result of its insurance claims process. All of this was complicated by a weak internal control structure and a staff increasingly burdened by a growing number of problem loans and assets. FHA has continued to address these problems, and especially considering how far it had to go, has made credible progress. We were particularly pleased that FHA was able to quantify multifamily credit risk, link this risk assessment to its management strategy and calculate a loss reserve for the financial statements. We also believe FHA's action plan to address remaining problems is a comprehensive and serious effort which merits support and aggressive follow-through.

Having said that, it is important to provide some cautionary notes. First, a large portion of expected improvement to the MMI Fund's capital ratio depends on the ultimate performance of insurance written in 1992 and 1993. Even though the current economic environment is more favorable to FHA, the performance of these books of business will become more certain only as actual default experience emerges. The financial statements will not reflect the positive performance of these books for some time, even though their economic value is projected to be strongly positive. Second, FHA's internal control weaknesses are not solved and will still require a good deal of attention. Moreover, FHA does not have a good record of quickly implementing planned corrective actions, however well such actions were conceived. Often this has not been their fault. A tight budgetary environment makes any effort to invest resources in people and automated systems difficult at best. The is a particularly unusual circumstance for a financial institution like FHA, which despite having very good cost benefit justification for such an investment -- especially if its means preventing a large loan default and a costly claim payment -- simply is not allowed to use its resources in what may be a cost effective manner. For example, such an investment may allow FHA to more closely monitor its insured loan portfolio, better manage its credit risk, and perhaps most importantly, prevent unnecessary loan defaults and foreclosures.

Resource and Staffing Problems

By any measure, FHA is a huge financial institution that often enters into complex credit transactions involving many different types of loans. Because there is so much at stake, particularly with respect to a large or complex loan, financial institutions typically pay a lot of attention to them, normally by frequently monitoring the underlying financial strengths or weaknesses of the loans, and the condition of the property securing them. They are especially careful to closely watch those loans that begin to show problems. The reason it is so important to identify loan weaknesses as soon as they begin to manifest themselves, is that experience has shown that if loan problems go unattended (or under-attended), solutions become much more difficult and often more costly. Potential losses that are quickly identified and addressed are those most likely to be prevented. There is clearly a cost/benefit trade off between resources dedicated to the credit management process and portfolio performance. For a large and complex credit operation, this normally implies a fair degree of resource investment -- in terms of the experience and number of people involved, the means to train them, and modern tools for them to use.

As shown in the following graphic, we have been concerned for some time that HUD staff resources simply do not stack up with comparable institutions:



We believe that FHA's most critical staffing needs are in the multifamily insured and Secretary-held note servicing areas, and in the single family Secretary-held note servicing area. The shortage is all the more significant when one considers that FHA typically takes more credit risk than either state agencies or private institutions. The effect of this problem is exacerbated by the recent build-up of defaulted single and multifamily notes that have been assigned to FHA when the insured loans defaulted.

Improvements Needed to Early Warning and Loss Prevention

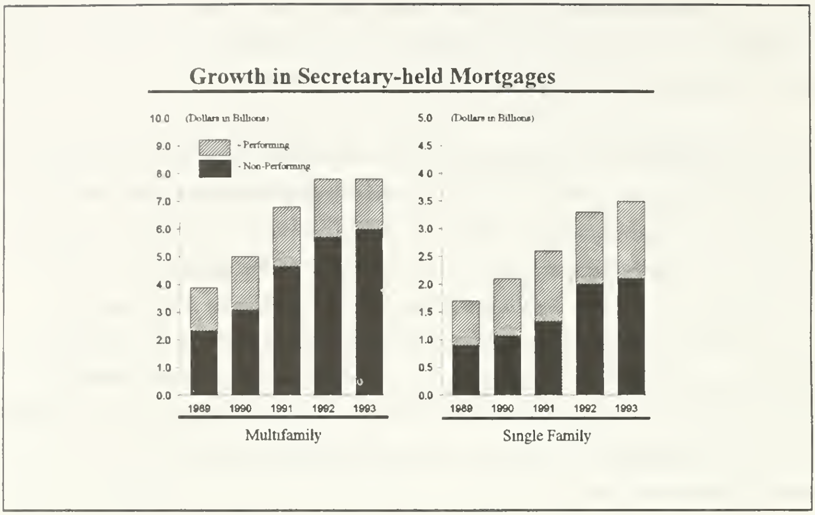
One way of addressing workload problems and improving the financial condition of FHA is to institute a comprehensive, flexible program to identify potentially troublesome loans quickly enough to allow for effective corrective measures. This implies having the ability to take substantive actions before a note assignment, or even before a pre-foreclosure sale takes place. For several years we have recommended that both the multifamily and single family program areas: (1) improve their ability to identify and assess insured loans that become potential problems; (2) place more emphasis on working with servicers to cure defaults and delinquencies before they become claims; and (3) develop a reporting mechanism for senior management to monitor the progress of actions to cure loan delinquencies and defaults and prevent losses. The most serious problems in early warning and loss prevention are in the multifamily area.

FHA has recently dedicated much effort to identifying problem loans in its insured multifamily portfolio. This is significant, because these are the loans for which preventive measures may yield immediate benefits in terms of preventing potentially large claim payments. But this process is still very staff intensive and often entails cumbersome manual information gathering and data reconstruction in order to develop a basis for making a proper decision. The lack of a complete and accurate database on the performance of insured multifamily loans, and the lack of an automated system to periodically assess and summarize this data continues to slow FHA's ability to address problem loans. Despite these impediments, FHA has made a laudable effort to improve its ability to identify problem loans and better understand why losses occur, and thus how they might be prevented in the current favorable interest rate environment. We believe legislative and resource assistance to FHA in this area would likely yield many benefits, and should be given careful consideration.

The single family area has experienced some of the same problems as the multifamily area, but to a much lesser degree. Unlike the multifamily area, single family has a quality control mechanism independent of the field offices -- the Mortgagee Monitoring Division -- which has been able to expand and enhance its activities. Even though improvements have been made, we still believe it is necessary for FHA to develop more flexibility in its single family loss prevention efforts. For example, a program that would make it easier to modify delinquent loans that have a good chance of curing might produce positive results, including reducing foreclosures and providing a less costly alternative to the assignment program. We understand that FHA is currently in the process of assessing alternatives to its present methods of addressing delinquent loans.

The Need to Promptly Resolve Secretary-Held Mortgages

For the last two years we have reported that FHA needs to quickly resolve, either through sales, restructuring, workout or foreclosure, its growing portfolio of single and multifamily Secretary-held notes. Virtually all of these notes were assigned to FHA when loans insured by FHA defaulted and claim payments were made. We have recently become more concerned about this issue because given budgetary constraints, the need to dedicate resources to manage this large portfolio might weaken FHA's overall internal control structure. Further, during our 1993 audit, we noted that: (1) the number of assigned multifamily and single family assigned notes continued to increase -- albeit at a slower pace; and (2) servicing of these loans has been deficient. The following chart depicts the growth in multifamily and single family notes assigned to FHA over the last 5 years:




As a result of our prior audits, we recommended that FHA develop a strategy for addressing this build-up of troubled assets and then periodically monitor progress against this strategy. FHA has developed such a strategy which entails, among other things: (1) selling performing mortgages and those assigned to FHA under the 221(g)(4) program, (2) setting goals for returning non-performing mortgages to a current status, and (3) making FHA's loan servicing efforts more efficient, by among other things, consolidating servicing activities into fewer locations. Subsequent audits should endeavor to monitor and report on FHA's progress against their action plan and assess whether it is effective. Other previously discussed actions to develop alternatives to the single family loan assignment program, and provide more flexibility in loss prevention would also help curtail the growth in notes being assigned to FHA.

Improving Automated Systems

Another way FHA could become more efficient, improve its staff utilization, and mitigate the constraints on its resources would be to make an investment in more quickly upgrading and modernizing its automated systems. While efforts have been made in the past, especially with respect to improving property management systems, a greater push to upgrade other critical systems might yield additional benefits through more comprehensive and timely information about loan performance. For example, completing the multifamily data base and multifamily national system would make loan monitoring and early warning considerably less staff intensive and would facilitate better decision-making about how resources might be better used. Further, implementing modern technology, such as electronic data interchange, might reduce FHA's paperwork burden and provide more timely and complete information about loans, borrowers and loan servicers. While HUD and FHA have prepared a comprehensive plan addressing weaknesses in its automated systems, it will take time to implement. We strongly encourage any support that would expedite implementation of new systems and improve the quality of FHA's financial information and its ability to provide service to its customers.

Summary

Mr. Chairman, we believe FHA is making progress to shore up its financial condition and address, in a serious and constructive way, the problems and challenges we and other auditors have reported for a long time. But for this progress to continue it is important that it continue to receive the attention of senior HUD management and this committee. To the extent legislative and budgetary support can demonstrably accelerate FHA's improvement, and ultimately save money, we encourage its continuation.

This concludes my statement. We would be happy to answer any questions.

**Price Waterhouse**
**Comments on Selected Questions from**
**Congresswoman Roukema**

*1.a.* ***What were the assumptions that allowed the IG and Price Waterhouse to come to this conclusion (capital ratio is 1.44%)? I mean this in terms of economic climate, premium refund policy, and refinancing activity. How do these factors, and others that we may not be aware of play into the determination of capital ratio standard of 1.44%?***

Our estimates of the economic value and capital ratio of the MMI Fund are based on numerous assumptions. Although a change in any one of these assumptions would be likely to result in change in our estimates, the sensitivity analysis that we conducted as part of our Actuarial Review suggests that the Fund's soundness would not be significantly affected by a minor change in any single assumption or class of assumptions.

For more information regarding the economic assumptions used in our Review, see page 22 of the FY 1994 Actuarial Review. These assumptions were based on DRI's May 1994 forecasts. Assumptions regarding premium refund policy were based on FHA's current premium refund schedule, which is provided on page B-7 of the Review. Lastly, the projected level of future refinancings was estimated using a four-step process that is described in detail on pages 65-69 of the Review.

*1.b.* ***If there were slight changes in your assumptions, such as the economic trend, etc., how would the capital ratio change?***

The sensitivity analysis that was included in Section VI of the Actuarial Review provides additional information regarding the range of possible outcomes the Fund might experience. These scenarios, which range in severity from minor changes in expected performance to worst case or "stress test" scenarios, indicate that the Fund should comfortably meet the 2.0% capital ratio mandated by Congress for FY 2000.

*2.* ***There has been speculation by some experts that the Actuarial study is highly speculative and cautious. I interpret that to mean that although there was a 1.44% determination, there were man aspects of the audit and study that caused Price Waterhouse to "hedge" its professional call. Could you comment on that concern?***

The 1.44% capital ratio is our best estimate of the Fund's capital ratio, given the information available. The estimates presented in the Actuarial Review require projections of events thirty years into the future. These projections are dependent upon a number of assumptions each of which has uncertainty with regard to how the future will actually occur. To take this uncertainty into account, we completed sensitivity analysis, where we varied the assumptions, and assessed the results. The results of this sensitivity analysis did not contradict over basic findings.

2.a. ***As a follow-up, what were the effects of the substantial refinancing activity during FY 1993? Are those refinances less or more risky than previous years? It is possible that the riskier borrowers remained with FHA, an if so, was that taken into account in determining a 1.44% capital ratio?***

The substantial refinancing activity during FY 1993 increased the estimated economic value, because the Fund avoids paying claims in the future on the loans that prepaid, paying only a small refund of the upfront premiums instead. Given that many of these mortgages were high-risk loans that entered the fund during the mid-to-late 1980s, the claims avoided were substantial.

Sufficient data will not be available to determine whether the refinances are more or less risky than previous years until we have at least three to five years of data on their loan performance. We have performed sensitivity analysis on the loan performance on the refinancings and on the loans that remained in the fund. The results of our sensitivity analysis show that under all but the most extreme scenarios, the effect on estimated economic value and capital ratios is moderate. Under all scenarios, we project that the Fund will still comfortably exceed the FY 2000 NAHA-mandated capital ratio of 2.00 percent.

2.b. ***What is the loan-to-value ratios on these refinanced FHA mortgages and what impact, positively or negatively, did this activity have on the MMI Fund in FY 1993?***

Strong evidence indicates that the recent refinanced loans originally entered the Fund with an initial loan-to-value distribution virtually identical to all loans. However, good information does not exist on the loan-to-value ratio of these loans at the time of refinancing. Until more accurate data is available regarding the composition of the loans that refinanced we will continue to assume that these loans will perform in the future as they did in the past. Our current estimates of the economic effects of the refinance loans on the MMI Fund indicate that they will have a slightly negative impact on the Fund's economic value. This is due to a combination of higher claim rates and a significantly lower premium structure for these loans.

In the Actuarial Review we tested the sensitivity of the estimated economic value and capital ratio to potential biases in our estimates by increasing the claim rates. In all scenarios, the Fund is still projected to comfortably exceed the FY 2000 capital ratio of 2.00 percent.

*3. Please see response provided by the Inspector General of HUD.*

*4.a. Will the this expansion (increases in the FHA mortgage loan limits) "cut" into private mortgage Insurance business? or, Will this expansion serve current underserved markets whose homeownership needs are not being met by the private sector?*

We have not performed any analysis of the effect that increased loan size limits will have on the MMI Fund. To the extent that FHA serves populations and regions that are chronically underserved by the private mortgage insurance industry, these changes will have only a limited effect on PMI business.

*4.b. If the FHA expansion will serve current underserved markets, then what are those markets? (minorities, inner-cities, first-time homebuyers, high l-t-v loans, etc.)*

As stated above, we have not performed any analysis of the market segments or populations that are likely to be served by the increased loan size limits proposed by FHA. However, to the extent that these limits enable a larger number of borrowers in high-cost areas to qualify for FHA insurance, we might expect participation rates in inner cities, particularly those in the Northeast and West to increase.

*5. Please see response provided by the Inspector General of HUD.*

*6.a. In light of the IG/Price Waterhouse audit, do you think it prudent for FHA to begin paying distributive shares once again?*

Payment of distributive shares will reduce the amount of capital FHA has to cushion against unexpected future losses. However, by effectively decreasing the price of FHA insurance, distributive shares may also increase the demand for FHA insurance. Paying distributive shares is a policy decision that FHA must make.

*6.b. On a broader level, do you think that it would be prudent at this time to revisit the provisions of NAHA and, if so, what changes would you make regarding the current program's structure?*

It may be beneficial to revisit the provisions of NAHA in the future to determine whether the NAHA premium structures are optimally meeting FHA's goals of providing affordable single family housing opportunities, while ensuring an actuarially sound MMI Fund. Both legislators and FHA may find it useful to regularly assess

NAHA's success in restoring the financial health of the MMI Fund and, perhaps, its impact on adversely affecting FHA's ability to meet its mission of providing affordable housing to low and moderate-income Americans.

7.a. ***Price Waterhouse states that the entire MMI books of business from FY 1975 through FY 1993 are generating a negative cash value of -$6.5 billion. This means that future cash outflow from the Fund to cover claims and other costs associated with loans on the MMI Fund books is $6.5 billion more than cash inflows these loans will generate through premiums, recoveries and other income. Given Price Waterhouse's statement, is it premature to argue that future FHA loans will "bail-out" the current loans?***

Although the MMI Fund is projected to have large future negative cash outflows related to its current book of business, these cash outflows must be viewed against FHA's current level of capital resources, now estimated to be over $9 billion. In fact, Price Waterhouse estimates the Fund has or will develop $4.554 billion in excess of what it needs to cover its liabilities and is not reliant on future FHA loans to "bail-out" the current loans.

FHA's MMI Fund collects a large portion of its premiums upfront, before any claims are made against the Fund. The large positive value of the current capital resources represents in part this accumulated upfront premium revenue. As claims are received in the future, these capital resources are drawn down to pay claims. Since the future cashflows are largely comprised of claim payments, we would expect them to be negative. The important point, however, is that the current capital resources number, is considerably greater than the value of future negative cash outflows. In a sense, FHA is like a service provider that is paid for a service in advance. FHA takes in money in the beginning of an insurance contract and pays the cost of providing the service later on when a loan defaults. This process is no different than many other transactions in which payment for a service is made prior to the delivery of that servicer.

7.b. ***In light of this large negative cash situation, is it premature to determine whether the single family is now on a solid financial (actuarial) foundation?***

As explained above, the Fund is not in a "large negative cash position," and is not projected to be in such a position in the future. The soundness of the Fund is to a large extent a result of FHA's current level of capital resources, and thus is not based on "premature" determinations.

United States General Accounting Office

GAO

Testimony

Before the Subcommittee on Housing and Community Development, Committee on Banking, Finance, and Urban Affairs,
House of Representatives

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# MORTGAGE FINANCING

# Financial Health of FHA's Home Mortgage Insurance Program Has Improved

Statement of Jacquelyn L. Williams-Bridgers, Associate Director, Housing and Community Development Issues, Resources, Community, and Economic Development Division

GAO/T-RCED-94-255

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here again to present the results of our latest assessment of the actuarial soundness of the Mutual Mortgage Insurance Fund (Fund) that we are conducting at the request of this Subcommittee. We presented a similar assessment of the Fund through fiscal year 1991 in a testimony before this Subcommittee on July 27, 1993.[1] Our testimony today will present the results of our ongoing assessment of the actuarial soundness of the Fund as of the end of fiscal years 1992 and 1993. The results of our work will be included in a report to the Subcommittee within the next few months.

As you know, the Fund is administered by the Department of Housing and Urban Development's (HUD) Federal Housing Administration (FHA). It provides insurance currently valued at about $269 billion for private lenders against losses on single-family mortgages. During the 1980s, the Fund, which historically had been financially self-sufficient, began to experience substantial losses primarily because foreclosure rates on homes supported by the Fund were high in economically stressed regions. In order to place the Fund on an actuarially sound basis, legislative reforms, such as requiring FHA borrowers to pay more in insurance premiums, were made in November 1990.

Concerned about the current financial health of FHA's Fund and the impact of reforms, this Subcommittee asked us to determine whether the Fund has sufficient financial reserves to meet estimated future losses resulting from the payment of claims on foreclosed mortgage loans. Specifically, we were asked to (1) estimate, under different economic scenarios, the economic net worth[2] of the Fund as of the end of fiscal year 1993; (2) assess the progress made by the Fund in achieving the legislatively prescribed capital ratios; and (3) compare our estimate with the estimate prepared for FHA by Price Waterhouse.

In summary, although there is uncertainty associated with any forecast, the economic value of FHA's Fund clearly has improved significantly in recent years, and the Fund is on the way to accumulating sufficient capital reserves to be considered actuarially sound under the law. As of September 30, 1993, the Fund had capital resources of about $9.7 billion which were sufficient to cover the $4.8 billion in expenses we estimate the Fund will incur in excess of anticipated revenues over the life of the loans outstanding at that time. The remaining $4.9 billion represents the Fund's economic net worth or capital--an

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[1]Homeownership: Actuarial Soundness of FHA's Single-Family Mortgage Insurance Program (GAO/T-RCED-93-64, July 27, 1993).

[2]The current cash available to the Fund, plus the net present value of all future cash inflows and outflows expected to result from outstanding mortgages in the Fund.

improvement of about $7.6 billion from the lowest level reached by the Fund just 3 years ago. Legislative and other program changes have helped restore the Fund's financial health, but favorable prevailing and forecasted economic conditions in fiscal year 1993 were primarily responsible for this improvement.

Although the Fund has made a substantial financial improvement recently, we estimate it fell about $3 billion short of achieving the legislative mandate for capital reserves by the November 1992 deadline. However, it surpassed the 1992 mandate for capital reserves by the end of fiscal year 1993. Whether the Fund can sustain this progress and attain the legislative target for reserves of 2 percent by November 2000, thereby achieving actuarial soundness under the law, and maintain that ratio thereafter, will depend on many economic and program factors that will affect the financial health of the Fund this year and over the next 6 years.

While there are some differences in the economic modeling techniques used and the assumptions made, our estimate of the economic value of the Fund ($4.9 billion) is similar to that of Price Waterhouse ($4.6 billion).

Before I present our assessment of the Fund's actuarial soundness in detail, let me briefly outline the purpose of FHA's single-family mortgage insurance program's Fund and the history of its financial condition.

PURPOSE AND FINANCIAL HISTORY OF FHA'S FUND

FHA was established in 1934 under authority granted to the President by the National Housing Act (P.L. 73-479). The primary purpose of FHA's Fund is to insure private lenders against losses on mortgages financing purchases of one to four housing units. To cover these losses, FHA deposits insurance premiums from participating home buyers in the Fund. According to 12 U.S.C. 1709, the Fund must meet or endeavor to meet statutory capital ratio requirements designed to achieve actuarial soundness; that is, it must contain sufficient reserves and funding to cover estimated future losses resulting from the payment of claims on defaulted mortgages and administrative costs. A determination of actuarial soundness requires the use of an accrual basis of accounting.[3] A primary objective of accrual accounting is to report the financial position and results of an entity's operations on the basis of measurable events, regardless of whether cash has changed hands. The accrual concept is

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[3]An accrual basis of accounting matches, or recognizes, the receipt of revenues and the expenditures of funds to produce that revenue in the same fiscal time period rather than in the period when they actually occur, which may be in different fiscal years.

particularly important for an entity such as FHA (or any insurance enterprise) because the actual payout or collection of cash may precede or follow by a substantial time period the event that gave rise to the cash transaction. Thus, a favorable cash position, or positive cash flow, at any given point may not reflect the true financial position of the entity.

The Fund remained relatively healthy until the 1980s, when losses were substantial, primarily because foreclosure rates were high in economically stressed regions, particularly in the Rocky Mountain and Southwest regions. For example, in fiscal year 1988 the Fund lost $1.4 billion. If the Fund were to become exhausted, the U.S. Treasury would have to directly cover lenders' claims and administrative costs.

In response to the Fund's financial problems, among other things, the Omnibus Budget Reconciliation Act of 1990 (P.L. 101-508) was enacted in November 1990. This legislation contained reforms to FHA's single-family mortgage insurance program designed to place the Fund on an actuarially sound basis. The legislation, among other things, required FHA borrowers to pay more in insurance premiums over the life of the loans by adding a risk-based annual premium to the one-time up-front premium. It effectively raised the present value of the insurance premium from the then 3.8 percent of the loan amount to 5.5 to 6.8 percent, depending on the amount of the down payment made. It accomplished this change with two actions: lowering the up-front premium from 3.8 to 2.25 percent of the loan amount over a 4-year transitional period and, during the same period, phasing in a new annual premium of 0.5 percent or 0.55 percent of the loan balances: those borrowers who make higher down payments pay the annual premium for a shorter period. The legislation also mandated that FHA's Fund attain a capital ratio of 1.25 percent by November 1992 and required the Secretary of HUD to endeavor to ensure a capital ratio of 2 percent by November 2000 and maintain at least a 2 percent ratio at all times thereafter. The capital ratio was defined by the act as the ratio of the Fund's capital or economic net worth to its unamortized insurance-in-force. Other changes made by the legislation in response to the Fund's financial problems included (1) limiting the loan-to-value ratio to a maximum of 97.75 percent of appraised value on homes whose appraised value exceed $50,000 and (2) effectively suspending payment of distributive shares (distribution of excess revenues to mortgagors) until the Fund is actuarially sound.

We have concluded that in addition to economic factors, poor program management and waste, fraud, and abuse contributed to the losses sustained by FHA's Fund. The full extent of losses attributable to these factors is not known. As we have pointed out in previous testimonies and reports, some of the major management problems facing HUD concern FHA's single-family program. For example, the absence of internal controls over

FHA's single-family property disposition management systems allowed private real estate agents to steal millions of dollars in FHA funds. Moreover, we reported that a direct correlation exists between the effectiveness of internal controls, the accuracy and timeliness of financial information, and the magnitude of losses incurred by FHA as well as by other HUD programs.[4]

We and HUD's Inspector General have been reporting on these management problems since the early 1980s. HUD has taken steps to address some of these problems and to strengthen FHA's financial position in the areas of property disposition, underwriting practices, monitoring of lenders, and reforms to accounting systems to prevent fraud in the future. However, we have concluded that much work remains to be done by HUD and FHA to resolve the underlying causes of FHA's problems, such as inadequate information and financial management systems. Any success achieved by HUD and FHA in reducing FHA's losses through better management will improve the financial health of the FHA Fund.

## OUR ESTIMATES OF THE FUND'S ECONOMIC NET WORTH

The Fund had amortized insurance-in-force valued at about $286 billion as of September 30, 1992, and $269 billion as of September 30, 1993. To estimate the economic net worth of, and resulting capital ratios for, these loans over their life of up to 30 years, we developed an economic model of FHA's home loan program. We generated three different economic scenarios, assuming for each a different rate of appreciation in house prices over the next 30 years. The actual economic net worth and capital ratios of the Fund--and the validity of our estimates--will depend on a number of future economic factors, including the rate of appreciation in house prices over the life of the FHA mortgages of up to 30 years. This factor is significant because, as house prices rise, the borrowers' equity increases and the probability of defaults and subsequent foreclosures decreases. The house price appreciation, interest, and unemployment rates we used were based on forecasts from DRI/McGraw-Hill, Inc., a private economic forecasting company.

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[4]See Impacts of FHA Loan Policy Changes on Its Cash Position (GAO/T-RCED-90-70, June 6, 1990); HUD Reforms: Progress Made Since the HUD Scandals but Much Work Remains (GAO/RCED-92-46, Jan. 31, 1992); and Letter to the Ranking Minority Member, Subcommittee on Housing and Community Development, House Committee on Banking, Finance and Urban Affairs (B-249052, Sept. 30, 1992).

A more detailed discussion of our modeling approach for forecasting the economic net worth of FHA's Fund appears in appendix I. We will present a complete description of our models in our report to the Subcommittee.

Economic Net Worth Estimates of FHA's Fund Under Three Scenarios

Table 1 presents our estimates of the economic net worth and resulting capital ratios for the FHA mortgage loans outstanding as of September 30, 1992, and September 30, 1993, under each of our three economic scenarios. Although future rates of appreciation in house prices are uncertain, to ensure that our estimates were conservative, we placed greater reliance on our mid-range baseline economic scenario because it assumes a slightly lower house price appreciation rate than the rate forecasted by DRI/McGraw-Hill, Inc. Under this scenario, we estimated that the Fund had an economic net worth of about $600 million and resulting capital ratio of 0.21 percent at the end of fiscal year 1992. We also estimated that the Fund had an economic net worth of about $4.9 billion and resulting capital ratio of 1.83 percent at the end of fiscal year 1993. This estimate represents an improvement of about $7.6 billion from the lowest level reached by the Fund--a negative $2.7 billion estimated by Price Waterhouse at the end of fiscal year 1990.

Under our low-case economic scenario, which assumes a lower rate of appreciation in house prices than our baseline, we estimated that the Fund's economic net worth and capital ratios would be lower. Conversely, under our high-case economic scenario, which assumes a higher rate of appreciation in house prices than our baseline, we estimated that the Fund's economic net worth and capital ratios would be greater.

Table 1: GAO's Estimates of the Economic Net Worth and Capital Ratios of FHA's Fund as of September 30, 1992, and 1993

| | Estimated economic net worth (in billions of dollars) | | Estimated capital ratios (percentage) | |
|---|---|---|---|---|
| GAO scenarios | FY 1992 | FY 1993 | FY 1992 | FY 1993 |
| High-case | $0.99 | $5.2 | 0.35 | 1.92 |
| Baseline case | 0.60 | 4.9 | 0.21 | 1.83 |
| Low-case | -0.34 | 4.0 | -0.12 | 1.47 |

Factors Contributing to the Fiscal Year 1993 Growth in the Fund's Economic Net Worth

As shown in table 1, we estimate that the economic net worth of the Fund increased under our baseline scenario by about $4.3 billion during fiscal year 1993. This increase occurred even though during fiscal year 1993 large numbers of FHA borrowers lowered their interest rates by refinancing their mortgages conventionally, which resulted in partial refunds of their insurance premiums. The financial improvement in the Fund is attributable to several economic and program factors working together to (1) increase the estimated economic net worth of loans endorsed by FHA in fiscal year 1992 and earlier years and (2) result in our estimate of a positive contribution to economic value made by those loans endorsed by FHA in fiscal year 1993. Table 2 summarizes the factors contributing to the $4.3 billion increase in economic net worth during fiscal year 1993.

Table 2: Factors Contributing to the Increase in Economic Net Worth of FHA's Fund During Fiscal Year 1993

| Economic and program factors | Fiscal year 1993 increase in economic net worth (in billion of dollars) | |
|---|---|---|
| Changes in value of fiscal year 1992 and earlier years' loans | | |
| Improvement due to actual loan performance data in 1993 | $1.0 | |
| Lower forecasted foreclosures and prepayments in 1994 and beyond | 0.3 | |
| Reduction in premium refunds paid | 0.5 | |
| Interest earned on investments | 0.7 | |
| Other factors | 0.3 | |
| Total changes in value of fiscal year 1992 and earlier years' loans | | $2.8 |
| Value added by fiscal year 1993 loans | | 1.5 |
| Total change in value of the Fund in fiscal year 1993 | | $4.3 |

We estimate under our baseline scenario that as of the end of fiscal year 1993, the contribution made to the economic net worth of the Fund on the basis of loans endorsed by FHA in fiscal year 1992 and earlier years increased about $2.8 billion from $0.6 billion at the end of fiscal year 1992 to $3.4 billion at the end of fiscal year 1993. This large increase accounts for about 65 percent of the increase in the Fund's economic value; the remaining 35 percent, or $1.5 billion, was attributable to the value added by fiscal year 1993 loans.

The $2.8 billion increase in the Fund's value is attributable to four primary factors. About $1 billion, or 35 percent, of this increase is attributable to updated data showing that these loans performed better in fiscal year 1993 than previously forecasted. This occurred, in part, because during fiscal year 1993 house prices increased more rapidly and the unemployment rate was lower than in previous economic forecasts. About $0.3 billion, or 11 percent, of the increase is due to our revised forecasts for loan foreclosures and prepayments for these loans during fiscal year 1994 and beyond. These revisions resulted largely from revised assumptions of future economic conditions that, in combination, had a favorable financial effect on the Fund. About $0.5 billion, or 18 percent, of the increase occurred because our 1993 forecast takes into account that effective January 1, 1994, FHA reduced the amount of premium refunds it will pay to borrowers who pay their mortgages in full before the end of their mortgage terms. Interest earned on investments accounted for $0.7 billion, or 25 percent, of the increase; the remaining 11 percent was attributable to other factors.

We estimate, under our baseline scenario, that loans endorsed by FHA in fiscal year 1993 contributed about $1.5 billion dollars to the economic net worth of the Fund. This represents the second consecutive year in which the Fund's new loans made a substantial contribution to the Fund's economic value.[5]

Our analysis of the loans endorsed by FHA in fiscal year 1993 also shows the importance of the program changes made by the Congress and FHA in recent years to the Fund's economic value. Beginning on July 1, 1991, FHA borrowers were subject to the higher premium payments mandated by the Omnibus Budget Reconciliation Act of 1990. We estimate that if FHA borrowers in fiscal year 1993 had to pay only the pre-act premiums, the economic net worth of the Fund at the end of fiscal year 1993 would have been about $4.1 billion, or $.8 billion (16 percent) less than our baseline estimate of $4.9 billion. Similarly, we estimate that if FHA had not revised its premium refund schedule, the economic net worth of the Fund at the end of fiscal year 1993 would have been about $4.4 billion, or $0.5 billion (10 percent) less than our baseline estimate of $4.9 billion.[6]

## SUBSTANTIAL PROGRESS MADE TOWARD ACTUARIAL SOUNDNESS

While FHA's Fund did not achieve the November 1992 mandated capital ratio of 1.25 percent of amortized insurance-in-force, it exceeded this ratio by the end of fiscal year 1993 (1.83 percent), making significant progress during that year toward achieving the November 2000 capital ratio of 2 percent needed for

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[5]We estimate that loans endorsed by FHA in fiscal year 1992 contributed about $1.2 billion to the economic value of the Fund.

[6]Our estimate of the effect of the change in the premium refund schedule takes into account the effect of a smaller refund on the likelihood of foreclosures and prepayments as well as on the size of the refunds.

actuarial soundness. However, whether the Fund will be able to achieve the capital ratio by November 2000 and maintain that ratio thereafter will depend on a number of factors that will prevail this year and over the next 6 years. These factors include (1) economic conditions; (2) program changes, such as those that affect the FHA premium; and (3) the demand for FHA loans. We did not attempt to project the economic net worth and capital ratio of the Fund to the year 2000 because these factors are likely to change, as happened recently when FHA reduced the up-front insurance premium that FHA borrowers must pay on their mortgages.

As shown in table 1, our estimates are sensitive to future economic conditions, particularly house price appreciation rates. The Fund will not perform as well if actual economic conditions that prevail over the next 30 years replicate those we assumed in our low-case economic scenario. Our estimate of economic value for our low-case economic scenario is about $0.9 billion, or 18 percent, less than our baseline scenario. Under economic scenarios having generally favorable economic conditions but lower rates of appreciation in house prices, such as our low-case economic scenario, FHA's Fund would likely experience higher claims. As a result, economic value would decline.

Similarly, HUD recently reduced the up-front insurance premium that FHA borrowers must pay on their mortgages. FHA reduced the up-front premium charged FHA buyers to 2.25 percent of the loan amount, down from 3 percent. We estimate that had the 2.25 percent premium, rather than 3 percent, been in effect in fiscal year 1993 and the demand for FHA mortgages was unchanged, the economic value of the Fund would have declined by about $460 million, or 9 percent, from our baseline estimate.

A decline in home buyers' demand for FHA-insured loans could also adversely affect the economic value of the Fund and the attainment of the November 2000 capital ratio. Home buyers' demand for FHA-insured loans depends, in part, on the alternatives available to them. For example, higher loan-to-value ratios result in reducing the cash needed by borrowers to purchase a home. Some private mortgage insurers recently announced a plan to offer mortgage insurance coverage on conventional 97-percent loan-to-value ratio mortgages, which brings their terms closer to FHA's 97.75-percent loan-to-value ratio on loans for properties exceeding $50,000 in appraised value. While potential home buyers must consider many other factors when financing their mortgages--such as the fact that FHA will finance the up-front premium as part of the mortgage loan--this action by private mortgage insurers could reduce the demand for FHA-insured mortgage loans.

PRICE WATERHOUSE'S ESTIMATES OF THE FUND'S ECONOMIC NET WORTH

Price Waterhouse has performed annual actuarial reviews of the Fund for FHA since 1990. In its most recent report dated June 6, 1994, Price Waterhouse reported that the Fund had an economic net worth of about $4.6 billion compared to GAO's estimate of $4.9 billion and a resulting capital ratio of 1.44 percent of the unamortized insurance-in-force as of the end of fiscal year 1993 compared to GAO's estimate of 1.83 percent of the amortized insurance-in-force. It also reported last year that the Fund's capital ratio at the end of fiscal year 1992 (0.43 percent) did not meet the 1.25 percent capital ratio established by legislation for 1992. Price Waterhouse's latest report also projects that the Fund will meet the year 2000 capital ratio of 2 percent of the unamortized insurance-in-force with a capital ratio of 3.40 percent and that the economic net worth of the Fund will be $15.3 billion. These projections are based on forecasted economic assumptions and the assumption that FHA does not change its premium and refund policies.

Although our estimate of the Fund's economic value exceeds Price Waterhouse's estimate by about 6 percent, in view of the uncertainty associated with any forecast of the performance of the Fund's loans over their life of up to 30 years, these estimates can be considered roughly equivalent. Each of us used somewhat different modeling techniques and assumptions that account for some of the $300 million difference. However, in general our model and Price Waterhouse's use similar statistical techniques and rely on many of the same key factors, such as rates of appreciation in house prices and changes in mortgage interest rates, as important determinants of mortgage terminations and the economic value of the Fund.

While our estimates of the Fund's economic value are similar, our estimate of the Fund's capital ratio is higher than Price Waterhouse's estimate--1.83 percent compared to 1.44 percent. While some of the difference results from the slightly higher economic net worth we estimated, the primary reason for this difference is the fact that we used a lower end of fiscal year 1993 insurance-in-force amount (amortized insurance-in-force) to calculate the capital ratio than Price Waterhouse--$269 billion compared to Price Waterhouse's $317 billion of unamortized insurance-in-force. As discussed previously, the capital ratio was defined by the act as the ratio of the Fund's economic net worth to its unamortized insurance-in-force.[7]

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[7]However, the act defined unamortized insurance-in-force as the remaining obligation on outstanding mortgages, a definition generally understood to apply to amortized insurance-in-force.

The insurance-in-force amount we use differs from the amount used by Price Waterhouse primarily because we deleted loan principal payments made on mortgages to date to arrive at an amortized insurance-in-force amount of $269 billion. We calculated the capital ratio on the basis of amortized insurance-in-force and not on unamortized insurance-in-force, as did Price Waterhouse. We used amortized insurance-in-force for our calculations because FHA insured mortgages are in fact fully amortized over the 30 year life of the loans. Price Waterhouse used unamortized insurance-in-force for its calculations so as to be consistent with its previous reports and because the data on unamortized insurance-in-force are considered more reliable than the data on amortized insurance-in-force. If we had used unamortized insurance-in-force ($317 billion) in calculating the capital ratio, our estimate of the capital ratio would have been 1.55 rather than 1.83.

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In summary, Mr. Chairman, FHA's Fund made significant progress during fiscal year 1993 toward achieving the capital reserves needed for actuarial soundness under the law. Clearly, the legislative and other program changes have helped restore the Fund's financial health and reverse the trend of the late 1980s and early 1990s toward insolvency. However, it should be recognized that fiscal year 1993 was an unusually good year for FHA because actual economic conditions and forecasts of future economic conditions were favorable. Nevertheless, forecasting economic net worth and resulting capital ratios to determine whether FHA will have the funds it needs to cover its losses over the life of the loans it has insured of up to 30 years is uncertain. Loan performance, and therefore economic net worth and capital ratios, will depend on a number of economic and other factors, particularly on the rate of appreciation in house prices and program policies such as premiums charged FHA borrowers that prevail over that period. Loan performance will also be affected by the demand for FHA-insured loans, a demand that depends, in part, on the alternatives available from private mortgage insurers. It is important to carefully balance desires to assist home buyers against the government's potential financial risk and liability and expectations of the housing market's future performance.

Mr. Chairman, this concludes my statement. We would be pleased to respond to any questions that you or Members of the Subcommittee may have.

## GAO'S ECONOMIC MODEL

To estimate the economic net worth of FHA's Fund as of September 30, 1992, and September 30, 1993, and its resulting capital ratios under different economic scenarios, we examined existing studies on the single-family housing programs of both HUD and the Department of Veterans Affairs (VA), academic literature on the modeling of mortgage defaults and prepayments, and previous work performed by Price Waterhouse, HUD, VA, GAO, and others on modeling government mortgage programs. On the basis of this examination, we developed economic and cash flow models that we used to prepare our estimates. For these models, we used data supplied by FHA and DRI/McGraw-Hill, a private economic forecasting company.

Our economic analysis estimated the historical relationships between certain explanatory factors and the probability of loan foreclosure and prepayment. To estimate these relationships, we used data on the performance of FHA-insured home mortgage loans originated from fiscal years 1975 through 1993. Also, using our estimates of these relationships and of economic conditions, we developed a baseline forecast of future loan performance to estimate economic net worth and the resulting capital ratio. We then developed additional estimates that assumed higher and lower future rates of appreciation in house prices; the scenario with the lower rate of house price appreciation also assumed higher unemployment.

We estimated future house prices by multiplying the initial value of the property at the time of loan origination by the DRI/McGraw-Hill forecasts of the annual increase in the median house price not adjusted for inflation. The rate of change in the median house price reflects the price of houses actually sold each year. Because new houses are larger and include more amenities than existing homes, the median sales prices of new homes will usually increase faster than the median sales prices for existing homes. In addition, the value of existing homes depreciates over time. The relevant consideration to the FHA homeowner, however, is how much the value of his or her house has increased since purchase, not how much the value of the general housing stock has changed. Because of these considerations, we adjusted the estimated rate of appreciation in existing house prices downward by 2 percent annually to account for changes in housing quality and depreciation. Also, to ensure that our estimates were conservative, we subtracted an additional 1 percent annually from DRI's forecasts. While the rates of appreciation in house prices we used were different for each state, the average[1] rates of appreciation for each fiscal year for our baseline scenario were 1993--2 percent; 1994--4 percent; 1995 through 1996--3 percent, 1997--4 percent, 1998--3.5 percent. DRI did not forecast rates of appreciation after 1998. We used a constant 3.5 percent rate for fiscal year 1999 and beyond.

In addition, we estimated unemployment rates by using state forecasts of unemployment as reported by DRI. The national average of the DRI unemployment forecasts is 6.6 percent in fiscal year 1993, falling to 5.5 percent in fiscal year 1998.

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[1]The averages were weighted by each state's 1993 FHA market share.

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Table 1: GAO's Estimates of the Economic Net Worth and Capital Ratios of FHA's Fund as of September 30, 1992, and 1993

| | Estimated economic net worth (in billions of dollars) | | Estimated capital ratios (percentage) | |
|---|---|---|---|---|
| GAO scenarios | FY 1992 | FY 1993 | FY 1992 | FY 1993 |
| High-case | $0.99 | $5.2 | 0.35 | 1.92 |
| Baseline case | 0.60 | 4.9 | 0.21 | 1.83 |
| Low-case | -0.34 | 4.0 | -0.12 | 1.47 |

Although future rates of appreciation in house prices are uncertain, to ensure that estimates were conservative, GAO placed greater reliance on its mid-range baseline economic scenario because it assumes a slightly lower house price appreciation rate than the rate forecasted by DRI/McGraw-Hill, Inc.

Table 2: Factors Contributing to the Increase in Economic Net Worth of FHA's Fund During Fiscal Year 1993

| Economic and program factors | Fiscal year 1993 increase in economic net worth (in billion of dollars) | |
|---|---|---|
| Changes in value of fiscal year 1992 and earlier years' loans | | |
| Improvement due to actual loan performance data in 1993 | $1.0 | |
| Lower forecasted foreclosures and prepayments in 1994 and beyond | 0.3 | |
| Reduction in premium refunds paid | 0.5 | |
| Interest earned on investments | 0.7 | |
| Other factors | 0.3 | |
| Total changes in value of fiscal year 1992 and earlier years' loans | | $2.8 |
| Value added by fiscal year 1993 loans | | 1.5 |
| Total change in value of the Fund in fiscal year 1993 | | $4.3 |

GAO's analysis of the loans endorsed by FHA in fiscal year 1993 shows the importance of the program changes made by the Congress and FHA in recent years to the Fund's economic value.

Impact on FY 93 economic value of

--the higher premium payments mandated by legislation — $0.8 billion (16 percent) less than our baseline estimate of $4.9 billion.

| | |
|---|---|
| --revised premium refund schedule | $0.5 billion (10 percent) less than our baseline estimate of $4.9 billion |

Also, GAO estimates that had the 2.25 percent premium, rather than 3 percent, been in effect in fiscal year 1993 and the demand for FHA mortgages was unchanged, the economic value of the Fund would have declined by about $460 million, or 9 percent, from our baseline estimate.

Questions from Congresswoman Marge Roukema to GAO (Jackie Williams-Bridgers)

1. The bottom line in the discussions regarding the Actuarial Soundness of the MMIF is whether the estimations are correct. The IG/Price Waterhouse study indicates that the capital ratio is 1.44%.

a. What were the assumptions that allowed the IG and Price Waterhouse to come to this conclusion? I mean this in terms of economic climate, premium refund policy, and, refinancing activity. How do these factors, and others that we may not be aware of play into the determination of capital ratio standard of 1.44%?

b. If there were slight changes in your assumptions, such as the economic trend, etc., how would the capital ratio change?

2. There has been speculation by some experts that the Actuarial Study is highly speculative and cautious. I interpret that to mean that although there was a 1.44% determination, there were many aspects of the audit and study that caused Price Waterhouse to "hedge" its professional call. Could you comment on that concem?

a. As a follow-up, what were the effects of the substantial refinancing activity during FY 93? Are those refinances less or more risky than previous years? Is it possible that the riskier borrowers remained with FHA, and if so, was that taken into account in determining a 1.44% capital ratio?

b. What is the loan-to-value ratios on these refinanced FHA mortgages and what impact, positively or negatively, did this activity have on the MMIF in FY 93?

3. It appears that this debate over FHA's involvement really comes down to whether FHA is capable of absorbing an expansion of its program. In other words, whether FHA has the capacity to manage effectively its mortgage insurance business and the ancillary activities such as assignment, foreclosure, property maintenance, and property disposition.

a. What is FHA's capacity to manage effectively its mortgage insurance business?

b. Given the proposed expansion of FHA through increases in the FHA mortgage loan limit and the risk-sharing program, will FHA have the capacity to handle its expanded business?

4. Given the increases in the FHA mortgage loan limits to $101,575 in its base floor and as high as $172,678 in high-cost areas, what is the impact of the FHA expansion on the private sector entities?

a. In other words, will this expansion "cut" into the private mortgage insurance business? or, Will this expansion serve current underserved markets whose homeownership needs are not being met by the private sector?

b. If the FHA expansion will serve current underserved markets, then what are those markets? (minorities, inner-cities, first-time homebuyers, high l-t-v loans, etc.)

5. The Committee Print for the Housing and Community Development Act of 1994 includes a new program called the "FHA single family mortgage insurance risk-sharing program."

a. What is the impact of that new risk-sharing program on the MMIF? Will this program affect the capital ratio?

6. The 1990 housing bill (National Affordable Housing Act), among other things, required that the payment of distributive shares by FHA be based on the actuarial soundness of the entire MMIF and not solely on the performance of loans endorsed during a particular year of business. It also require other provisions intended to make the financial footing of the MMIF meet safety and soundness requirements.

a. In light of the IG/Price Waterhouse audit, do you think it prudent for FHA to begin paying distributive shares once again?

b. On a broader level, do you think that it would be prudent at this time to revisit the provisions of NAHA and, if so, what changes would you make regarding the current program's structure?

7. Price Waterhouse states that the entire MMI books of business from FY 75 through FY 93 are generating a negative cash value of -$6.5 billion. This means that future cash outflows from the Fund to cover claims and other costs associated with loans on the MMIF books is $6.5 billion more than cash inflows these loans will generate through premiums, recoveries and other income.

a. Given PW's statement, is it premature to argue that future FHA loans will "bail-out" the current loans?

b. In light of this large negative cash situation, is it premature to determine whether the single family is now on a solid financial (actuarial) foundation?

RESPONSES OF MS. JACQUELYN L. WILLIAMS-BRIDGERS, GAO TO QUESTIONS FROM CONGRESSWOMAN MARGE ROUKEMA

QUESTION

1. The bottom line in the discussions regarding the actuarial soundness of the MMIF is whether the estimations are correct. GAO's study indicates that the capital ratio is 1.83%.

a. What were the assumptions that allowed you to come to this conclusion? I mean in terms of economic climate, premium refund policy, and, refinancing activity. How do these factors, and others that we may not be aware of play into the determination of capital ratio standard of 1.83%.

GAO RESPONSE

Our forecast, like any other, depends on a variety of assumptions. As a result, we prepared a base case forecast incorporating those assumptions and conducted sensitivity analyses to determine by how much this forecast would change if we changed our assumptions. Our assumptions about economic variables affected our forecasts of future loan foreclosures and prepayments, while our assumptions about FHA operations determined the cash flows that resulted from our estimated foreclosures and prepayments. Our key assumptions for our base case forecast are as follows:

Economic variables: We used forecasted values of three economic variables: house price appreciation rate, mortgage interest rate, and unemployment rate. For house price appreciation and unemployment rates we used different estimated rates for each state. Our house price appreciation rates were derived from DRI/McGraw-Hill forecasts of the annual increase in the median house price not adjusted for inflation. We adjusted the estimated rate for each state in each year downward by 2 percent to account for changes in housing quality and depreciation. To ensure that our estimates were conservative, we subtracted an additional 1 percent annually from DRI's forecast. While the rates varied by state, the approximate average rates, weighted by each state's 1993 FHA market share, were as follows: 1993--2 percent; 1994--4 percent; 1995--3 percent; 1996--3 percent; 1998--3.5 percent. Because DRI's forecasts did not extend beyond 1998, we used a constant 3.5 percent rate for 1999 and beyond. For mortgage rates we used DRI's forecast for each year of the average 30-year fixed rate mortgage interest rate on new houses. These rates ranged between 7.67 percent and 8.63 percent during the forecast period. For unemployment rates, we used DRI's state forecasts. The national average of the DRI unemployment rate forecasts is 6.6 percent for 1993, falling to 5.5 percent for 1998.

FHA operations: We made numerous assumptions about FHA operations, generally assuming that the future would resemble the past. For example, we assumed that FHA continues to use the premium refund schedule it introduced for loans prepaying in 1994. We assumed that for each book of business, FHA's acquisition cost ratio--the total amount paid by FHA to settle a claim and acquire a property, divided by the outstanding principal balance on the mortgage at the time of foreclosure--would remain unchanged from what we calculated they have been to date. These rates vary from a high of 1.39 percent for the 1975 book of business to a low of 1.08 percent for the 1992 book. Because we had no experience to draw on, we assumed that the ratio for the 1993 book would be the same as for 1992. Based on information reported by Price Waterhouse, we assume the time lag between the payment of a claim and the receipt of proceeds from the disposition of the property to be 7.8 months in both the past and the future. For FHA's loss rate--the dollar loss incurred on a claim divided by the claim amount--during the forecast period, we assumed a value of 38 percent, which is the average loss reported by FHA's financial auditors for fiscal year 1993 and is also comparable to the weighted average of losses over a longer period. On the basis of data in recent years' financial statements, we assumed that annual administrative expenses were 0.1 percent of the outstanding principal balance. Finally, we made assumptions about the discount rate used to convert income and expense streams, regardless of when they occur, into 1993 dollars. We applied discount rates that were intended to match as closely as possible the rate of return FHA likely earned in the past or would earn in the future from its investment in U.S. Treasury securities. As an approximation of what FHA earned, for each book of business we used a rate of return comparable to the yield on 7-year U.S. Treasury securities prevailing when that book was written to discount all cash flows occurring in the first seven years of that book's existence. We assumed that after seven years the Fund's investment was rolled over into new Treasury securities at the interest rate prevailing at that time and used that rate to discount cash flows to the rollover date. For rollover dates occurring in 1994 and beyond, we used 7 percent as the new discount rate.

QUESTION

1b. If there were slight changes in your assumptions, such as the economic trend, etc, how would the capital ratio change?

GAO RESPONSE

We conducted several sensitivity analyses to determine by how much our estimate of the Mutual Mortgage Insurance Fund's (Fund) economic net worth and capital ratio would change if we made different assumptions about key variables. In particular, we changed some of our economic assumptions to develop high and low case estimates. In our high case, we added 1 percentage point per year to our base case assumptions about the rate of house price appreciation. In our low case, we subtracted 1 percentage point per year from our base case and raised our estimated state unemployment rates by assuming that the state's 1993 unemployment rate would prevail from 1994 on as well. Under the high case, we estimate an economic net worth of the Fund of $5.2 billion and a capital ratio of 1.92 percent, while under the low case we estimate an economic net worth of $4.0 billion and a capital ratio of 1.47 percent. These estimates compare to our base case estimates of $4.9 billion for the Fund's economic net worth and 1.83 percent for the capital ratio. We also tested the sensitivity of our estimates to our assumed values of FHA's future loss rate and the discount rate used to convert future cash flows into 1993 dollars. We found that for our base case economic scenario, a one percentage point change in the loss rate (from 38 percent to either 37 or 39 percent) resulted in a $200 million change in the estimated economic net worth of the Fund and a capital ratio change of less than 0.1 percentage points. We found that applying a 1 percentage point higher or lower discount rate for future cash flows resulted in even smaller changes in the Fund's economic net worth and capital ratio.

QUESTION

2. There has been speculation by some experts that the actuarial study is highly speculative and cautious. I interpret that to mean that although there was a 1.83% determination, there were many uncertainties surrounding certain aspects of the study. Could you comment on that concern?

GAO RESPONSE

Any estimate of the future cash flows expected over the life of up to 30 years of existing FHA mortgage loans is subject to many uncertainties. Future cash flows on these loans depend on many economic, program, and other factors that will prevail in the future including interest rates, house price appreciation rates, unemployment rates, and program policies such as premiums charged FHA borrowers. For example, our baseline forecast of the economic value of FHA's Fund and resulting capital ratio of 1.83 percent as of September 30, 1993, assumes that distributive share payments will not be made from the Fund over the life of the loans outstanding as of that date. Should distributive share payments be resumed in the future, our estimate will need to be adjusted to recognize this change in program policy.

While neither our actuarial study nor any other such study can escape uncertainty, our study addresses uncertainty explicitly, by incorporating economic scenarios which are more optimistic and more pessimistic than our baseline scenarios.

QUESTION

2a. As a follow-up, what were the effects of the substantial refinancing activity during FY 93? Are those refinances less or more risky than previous years? Is it possible that the riskier borrowers remained with FHA, and if so, was that taken into account in determining a 1.83% capital ratio?

GAO RESPONSE

The substantial refinancing activity that occurred on FHA loans during fiscal year 1993 has created a class of FHA borrowers whose future behavior is more difficult to predict than the typical FHA borrower. About 8 percent of FHA's amortized insurance-in-force as of the end of fiscal year 1993 consists of streamlined refinanced mortgages for which there is little experience about the tendency for these loans to foreclose and/or prepay.

To understand the effect of the recent refinancing wave on the riskiness of FHA's portfolio, it may help to think of FHA borrowers as in three categories--low risk, moderate risk, and high risk. When interest rates decline, borrowers in all three categories are motivated to refinance their mortgages to lower their monthly payments.

Low risk FHA borrowers, those borrowers who have accumulated substantial equity in their properties and/or high income relative to mortgage payments, may choose to refinance in the private market, where fees are lower, but underwriting standards are more stringent. When this occurs, FHA loans on average become more risky because of the adverse selection effect of low risk borrowers exiting the program, leaving only moderate and high risk borrowers in the program.

On the other hand, moderate risk FHA borrowers may be willing to pay FHA's higher fees and obtain an FHA streamlined refinanced loan, thereby taking advantage of FHA's less stringent underwriting standards to lower their monthly payments. Because monthly payments for these borrowers are lowered following refinancing, these moderate risk loans become less risky to FHA than they were previously and FHA's portfolio of loans on average becomes less risky.

High risk FHA borrowers might not refinance either privately or through FHA and therefore are the riskiest of all FHA loans. There are many reasons why a borrower might not take advantage of a refinancing opportunity when interest rates decline. One is that the borrower might have a difficult time qualifying for a new mortgage because of some form of economic distress, such as unemployment or late payments.

While our model does not reliably estimate the effect of adverse selection because there is very limited experience on which to evaluate this effect, our model does estimate the magnitude of the payment reduction effect resulting from streamline refinancing. If the adverse selection effect of low risk loans leaving the program is stronger than the risk reduction effect resulting from the lower monthly payments on moderate risk loans which obtained streamlined refinancing, then the refinancing wave of 1993 made FHA's remaining portfolio more risky. If not, then risk has declined.

Although the safest loans in FHA's portfolio have departed, these loans still represented some risk that is no longer assumed by FHA. On the other hand, these borrowers paid up front premiums when their loans were originated, only part of which is refunded upon departure. We do not know, however, whether the decrease in risk to FHA's Fund from the loans that have been streamlined refinanced is large enough to offset the partial premium refunds.

However, the overall impact on the Fund of these streamlined refinance loans is probably positive, for reasons discussed in our response to question 2b. In this regard, our model does include in its forecasts of the Fund's economic value and capital ratios the beneficial effect that lower interest rates, hence, lower payment burdens, have on the risk assumed by FHA from streamlined refinanced mortgages. Similarly, our model estimates that those loans with no appraisals written after fiscal year 1983 (almost all of these are fiscal years 1992 and 1993 loans) are slightly more risky than loans with 100 percent loan-to-value (LTV), but this estimate is based on extremely limited information and should not be treated as firm until more experience is available. Our model also estimates the negative effect of high risk FHA loans which have not refinanced with FHA or the private market.

QUESTION

2b. What is the loan-to-value ratios on these refinanced FHA mortgages and what impact, positively or negatively, did this activity have on the MMIF in FY 93?

GAO RESPONSE

Because properties that were FHA streamlined refinanced were not required to be appraised, the LTV of these loans is unknown. However, since they represent pre-existing FHA business, whose risk has been reduced through lower interest rates and lower monthly payments, their impact on the financial health of the Fund is probably positive.

QUESTION

3. It appears that the debate over FHA's involvement really comes down to whether FHA is capable of absorbing an expansion of its program. In other words, whether FHA has the capacity to manage effectively its mortgage insurance business and the ancillary activities such as assignment, foreclosure, property maintenance, and property disposition.

a. What is FHA's capacity to manage effectively its mortgage insurance business?

b. Given the proposed expansion of FHA through increases in the FHA mortgage loan limit and the risk-sharing program, will FHA have the capacity to handle its expanded business?

GAO RESPONSE

Recently, concerns have been raised by the Department of Housing and Urban Development's Inspector General, Price Waterhouse, and GAO, regarding the agency's current work load, the adequacy of its current staffing level, and its ability to adequately monitor and service its existing portfolio of loans. In addition, the Department has been plagued for years by information systems that do not satisfy management needs or provide the information needed for adequate control over its programs. Many of these problems persist today, making it highly questionable whether FHA has the resources to adequately manage its current workload let alone take on additional responsibilities. We believe that the Congress should take these concerns into consideration when debating any proposals that would lead to an expansion of FHA's mortgage insurance program.

QUESTION

4. Given the increases in the FHA mortgage loan limits to $101,575 in its base floor and as high as $172,678 in high-cost areas, what is the impact of the FHA expansion on the private sector entities?

a. In other words, will this expansion "cut" into the private mortgage insurance business? or, Will this expansion serve current underserved markets whose homeownership needs are not being met by the private sector?

GAO RESPONSE

In our opinion, the proposed increase in the FHA mortgage loan limits will result to some extent in both impacts occurring--it will cut into the private mortgage insurance business and serve currently underserved markets. However, we do not know how much additional business FHA would receive if the loan limits were increased to $101,575 in its base floor and $172,678 in high cost areas, nor do we know the extent to which the additional FHA business generated represents business lost by private mortgage insurers (PMI) or loans to underserved markets whose homeownership needs are not being met by the private sector.

If the ceilings on FHA insured loans are increased, it should be expected that some FHA business will consist of loans that exceed the present ceilings. Most likely, some of this new FHA business will be generated by home buyers who could have obtained private mortgage insurance on their loans because FHA's insurance program does not exclude home buyers who qualify for private mortgage insurance from obtaining FHA insurance. However, this loss of business by PMIs to FHA might be small because home buyers who qualify for private insurance are likely to find it less expensive than FHA insurance. It is also likely that some of this new FHA business will be generated by home buyers who qualify for FHA insurance, but would not have qualified for private mortgage insurance because PMIs typically require higher down payments or employ more stringent underwriting standards.

Another impact of increasing FHA's mortgage loan limits could be that, some home buyers obtaining FHA insurance on loans that exceed the previous ceilings might have obtained FHA insurance to purchase a less expensive home if the old ceilings were still in effect. Yet another impact is that in low cost areas where the current ceiling is $67,500, raising the ceiling will set the loan limit above 95 percent of the areas' median housing prices.

QUESTION

b. If the FHA expansion will serve current underserved markets, then what are those markets? (minorities, inner-cities, first-time homebuyers, high l-t-v loans, etc.)

GAO RESPONSE

To the extent that FHA's expansion serves currently underserved markets, such markets are likely to be in neighborhoods that contain houses with market values that exceed the current ceilings, but are below, or only slightly above, the proposed ceilings. In some areas of the country, this may allow home buyers to obtain FHA insurance on houses in many neighborhoods in which they could not do so under the current ceilings (unless they made a very large down payment, in which case they would be unlikely to use FHA). But in other market areas, most neighborhoods may contain houses with market values that are below the current ceilings. In these market areas, raising the FHA ceiling might not open up new neighborhoods to FHA borrowers but would increase the share of housing that could be financed with FHA insured loans.

We do not know the extent to which home buyers obtaining FHA insurance in amounts exceeding the current ceilings would be minorities, an inner-city resident, first-time home buyers, or high LTV loans. During fiscal year 1993, about 16 percent of FHA borrowers were minorities, 35 percent lived in urban areas, and 35 percent were first-time home buyers. However, these percentages might be less for loans above the current ceiling because a smaller share of houses sold in that price range may be sold to home buyers with these characteristics.

While we do not know what the average LTV ratio would be for loans that exceed the current loan ceilings, LTV ratios tend to be about the same for loans of different sizes except for loans very close to the ceiling. For those loans, LTVs tend to be a little lower, on average. If this trend were to continue as the ceilings were raised, then the average LTV of new business resulting from raising the ceilings would be a little lower than the average LTV for existing loans.

QUESTION

5. The Committee Print for the Housing and Community Development Act of 1994 includes a new program called the "FHA single family mortgage insurance risk-sharing program."

a. What is the impact of that new risk-sharing program on the MMIF? Will this program affect the capital ratio?

GAO RESPONSE

Due to its more liberal underwriting standards, current FHA loans have a higher foreclosure rate than loans underwritten by private mortgage lenders. However, as long as the premiums charged are high enough to cover expected losses, FHA's Fund will remain actuarially sound. If a risk sharing program were initiated to provide FHA insurance on higher priced houses, this business (if underwritten using existing FHA standards) would also be more risky than private loans underwritten at this level. To preserve the soundness of the Fund, appropriate premiums would have to be charged to cover this risk. In addition, arrangements between FHA, Government National Mortgage Association, and State and local agencies would have to be carefully crafted to ensure that there was a genuine sharing of financial risk. Through a combination of equitable risk sharing and adequate premiums, the program could be designed to have little, if any, impact on the actuarial soundness (capital ratio) of the Fund. However, to the extent that the risk to FHA is substantially increased, consideration should be given to including this new program in FHA's Special Risk Fund.

QUESTION

6. The 1990 housing bill (National Affordable Housing Act), among other things, required that the payment of distributive shares by FHA be based on the actuarial soundness of the entire MMIF and not solely on the performance of loans endorsed during a particular year of business. It also contained other provisions intended to make the financial footing of the MMIF meet safety and soundness requirements.

a. In light of your study, do you think it prudent for FHA to begin paying distributive shares once again?

b. On a broader level, do you think that it would be prudent at this time to revisit the provisions of NAHA and, if so, what changes would you make regarding the current program's structure?

GAO RESPONSE

GAO strongly supported enactment of the Cranston-Gonzalez National Affordable Housing Act of 1990 (NAHA) and continues to support the provisions contained in that legislation, including the suspension of the payment of distributive shares. It is critical to the future financial health of the Fund that FHA only underwrite loans that are actuarially sound. Our analysis shows that in the first two years that the Cranston-Gonzalez provisions have been in effect, the Fund has shown substantial improvement--adding \$1.2 billion and \$1.5 billion to economic value in fiscal years 1992 and 1993, respectively. While the Fund did not achieve the November 1992 mandated capital ratio of 1.25, it exceeded it by the end of fiscal year 1993 (1.83 percent). However, it should be stressed that the Fund has not yet reached the 2 percent needed for actuarial soundness under the law. In addition, very little information is available on how well loans underwritten by FHA in fiscal years 1991 through 1993--critical years since enactment of NAHA in which the Fund's financial position substantially improved and record refinancing took place--will perform in the future.

Given the uncertainty surrounding any estimate of the Fund's economic net worth, we believe it prudent for Congress to defer making any major changes to the provisions enacted into law by the 1990 Housing Act until at least one more year of information is available on the foreclosure performance of the recent years books-of-business.

QUESTION

7. Price Waterhouse states that the entire MMI books of business from FY 75 through FY 93 are generating a negative cash value of -\$6.5 billion. This means that future cash outflows from the Fund to cover claims and other costs associated with loans on the

MMIF books is $6.5 billion more than cash inflows these loans will generate through premiums, recoveries and other income.

7a. Given PW's statement, is it premature to argue that future FHA loans will "bail-out" the current loans?

GAO RESPONSE

The actuarial soundness of the Fund depends on its economic net worth, not its future cash flow. Future cash flows are only one component of net worth. To determine soundness, one must consider premium income the Fund has already received for its existing loans as well as future cash outflows. Although there will be substantial outflows from the Fund in future years due to claims that will be made against the Fund following defaults on loans in the 1975 through 1993 books of business, that does not by itself imply that those books were unsound. In fact, the 1980 through 1991 books do show a negative economic value. However, both the 1992 and 1993 books are projected to have large positive economic values. That is, although future cash outflows for loans in those books will exceed future cash inflows, the premium income already collected will be more than sufficient to cover the excess.

Despite the positive books of the last two years and the period from 1975 through 1979, it is still true that the economic value of the loans insured for the entire period 1975 through 1993 is negative because of large losses associated with the 1981 through 1986 books. Nonetheless, because the Fund built up substantial assets on its pre-1975 business, we estimate that the economic value of the Fund as of the end of 1993 was about $4.9 billion. Price Waterhouse made a similar estimate. These estimates are based on loans insured through 1993; even if no future loans are insured, the Fund will have a positive economic net worth. Therefore, future loans are not necessary to "bail-out" current loans.

QUESTION

In light of this large negative cash situation, is it premature to determine whether the single family is now on a solid financial (actuarial) foundation?

GAO RESPONSE

The negative future cash flow on existing loans is not the appropriate measure to determine whether the Fund is actuarially sound. We analyzed the economic value of the Fund as of the end of fiscal year 1993 and estimated that its net worth at that time was about $4.9 billion, which gave the Fund a capital ratio of 1.83 percent of its amortized insurance-in-force. Therefore, although the Fund did not achieve the November 1992, mandated capital ratio of 1.25 percent, it exceeded this ratio by the end of 1993. During the past two years the Fund made considerable progress toward achieving the legislative target for actuarial soundness of a 2 percent ratio by November 2000. However, whether the Fund will be able to achieve that ratio by that time and maintain it thereafter will depend on a number of factors including economic conditions, program changes, and the demand for FHA loans. We did not attempt to project the economic net worth and capital ratio of the Fund to the year 2000 because these factors are likely to change.

**An Actuarial Review**
**for Fiscal Year 1993**
**of the**
**Federal Housing Administration's**
**Mutual Mortgage Insurance Fund**

**Final Report**

**May 31, 1994**

Price Waterhouse

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*Price Waterhouse*

June 6, 1994

The Honorable Nicolas P. Retsinas
Assistant Secretary for Housing-Federal Housing Commissioner
451 Seventh Street, Southwest, Room 9100
Washington, D.C. 20410

Dear Mr. Retsinas:

The Cranston-Gonzalez National Affordable Housing Act (NAHA) requires an independent actuarial analysis of the economic net worth and soundness of the FHA's Mutual Mortgage Insurance (MMI) Fund. We have completed the Fiscal Year 1993 Actuarial Review of the Mutual Mortgage Insurance Fund, and summarize our findings below.

The primary purpose of our review was to estimate:

- The economic value of the MMI Fund, defined as the sum of existing capital plus the net present value of current books of business

- The current and projected capital ratio, defined as the economic value divided by the total insurance-in-force.

We estimate that the MMI Fund economic value was $4.554 billion at the end of fiscal year (FY) 1993, and that the capital ratio was 1.44 percent. We project that the Fund economic value at the end of FY 2000 will be $15.254 billion, and that the capital ratio will be 3.40 percent.

The estimates presented here require projections of events thirty years into the future. These projections are dependent upon a number of assumptions, including economic forecasts by DRI and the assumption that FHA does not change its refund and premium policies. To the extent these assumptions, or others, are not accurate, the actual results will vary from our projections.

The full actuarial report explains these results and the reasons for the significant improvement since last year's actuarial review. If you have any questions, please feel free to call Barry Dennis at (202) 861-6265.

Very truly yours,

Price Waterhouse

## Executive Summary

The Cranston-Gonzalez National Affordable Housing Act (NAHA) requires an independent actuarial analysis of the economic net worth and soundness of the FHA's Mutual Mortgage Insurance (MMI) Fund. This report presents our findings with respect to this required analysis for Fiscal Year 1993.

The primary purpose of our review was to estimate:

- The economic value of the MMI Fund, defined as the sum of existing capital plus the net present value of current books of business
- The current and projected capital ratio, defined as the economic value divided by the total insurance-in-force

### Status of the Fund

NAHA mandated that the MMI Fund achieve a capital ratio of at least 1.25 percent by Fiscal Year 1992 (FY 1992) and of at least 2.0 percent by FY 2000. While last year's Actuarial Review estimated that the MMI Fund had not met the FY 1992 capital ratio requirement, we estimate that the MMI Fund's capital ratio has exceeded 1.25 percent as of the end of FY 1993. We project that the MMI Fund will exceed the 2.0 percent capital ratio mandated by NAHA for FY 2000. Specifically, we estimate that the FY 1993 capital ratio of the MMI Fund was 1.44 percent and project that the FY 2000 capital ratio will be 3.40 percent.

**Exhibit ES-1: Projected MMI Fund Performance for FY 1993 to FY 2000**

**($ in Millions)**

| Fiscal Year | Economic Value of the Fund* | Capital Ratio | Volume of New Endorsements | Insurance in Force | Economic Value of New Book of Business | Interest on Previous Business |
|---|---|---|---|---|---|---|
| 1993 | $4,554 | 1.44% | $65,165 | $316,527 | $1,262 | $0 |
| 1994 | $6,127 | 1.92% | $56,696 | $319,630 | $1,414 | $159 |
| 1995 | $7,198 | 2.09% | $47,182 | $344,318 | $856 | $214 |
| 1996 | $8,687 | 2.39% | $48,364 | $363,932 | $1,238 | $252 |
| 1997 | $10,235 | 2.67% | $47,688 | $383,966 | $1,244 | $304 |
| 1998 | $11,845 | 2.92% | $46,904 | $405,135 | $1,252 | $358 |
| 1999 | $13,518 | 3.17% | $46,363 | $426,643 | $1,258 | $415 |
| 2000 | $15,254 | 3.40% | $46,059 | $448,358 | $1,263 | $473 |

*The economic value for future years (FY 1994 through FY 2000) is equal to the economic value of the Fund at the beginning of the year, plus the interest earned on previous business, plus the economic value of the new book of business.

### Sources of Improvement in Status of the Fund

The much improved current position of the Fund reflects an increase in estimated current economic value of $3.149 billion between the end of FY 1992 and the end of FY 1993. A total of $953 million of this increase was anticipated in last year's Review. The remaining $2.196 billion increase is the net effect of unanticipated developments during FY 1993 and new economic forecasts ($2.654 billion), technical changes to the estimation models (-$0.932 billion), and changes in FHA refund and premium policies ($474 million).

The largest component of the improvement in the current status of the Fund is the effect of unanticipated developments during FY 1993. The most important development was the tremendous level of prepayments, increasing the estimated FY 1993 economic value by $1.201 billion. These unexpectedly high prepayments, which are due to lower interest rates, dramatically increased the estimated economic value, because the Fund avoids paying claims in the future on the loans that prepaid, paying only a small refund of the upfront premiums. Given that many of these mortgages were high-risk loans that entered the fund during the mid-to-late 1980s, the claims avoided were substantial. In addition, the forecast for the economy is currently more favorable with regard to claims than last year's forecast, resulting in an additional $869 million of estimated economic value.

The significant increase in the forecast FY 2000 capital ratio from the FY 1992 Review estimate of 2.44 percent to the current estimate of 3.40 percent is the net effect of an increase of 1.79 percentage points due to the unanticipated 1993 events and a revised economic forecast, a decrease of 1.00 percentage points due to technical refinements to the estimation models, and an increase of 0.17 percentage points due to the changes in FHA refund and premium policies. The largest change (an increase of 1.55 percentage points) is due to the more favorable new economic forecast. This new economic forecast affected the forecast FY 2000 capital ratio primarily through revised projections of claims rather than prepayments.

The estimates presented here require projections of events thirty years into the future. These projections are dependent upon a number of assumptions, including economic forecasts by

DRI/McGraw-Hill and the assumption that FHA does not change its refund and premium policies. To the extent these assumptions, or others, are not accurate, the actual results will vary from our projections.

**Impact of Economic Forecasts**

The economic value of the Fund and its pattern of capital accumulation to FY 2000 depends on several factors. One of the most important factors is the nation's future economy during the remaining lifetime of FHA's books of business. We capture the most significant factors in the U.S. economy affecting the performance of the Fund's books of business through the use of the following variables in our model:

- FHA mortgage interest rate
- Growth rate of constant quality house prices
- Growth rate of median household incomes

The performance of FHA's books of business, measured by their economic values, are affected by changes in these variables. Interest rates affect initial and ongoing payment burdens on household cash flows, and hence default risks. Interest rates also affect the potential for prepayments due to refinancing as prevailing interest rates change during the lifetime of each book. Faster average house price growth facilitates the accumulation of home equity which tends to significantly reduce the likelihood of borrower default. It also contributes to greater mobility and household asset portfolio rebalancing, leading to greater turnover of housing and refinancings, thus increasing prepayment rates. Faster income growth reduces the burden of mortgage payments on household cash flows over time, reducing risks of default and claims as mortgages mature.

The base case results in this report are based on DRI's baseline forecasts as of May 1994 for interest rates, constant quality house prices, and inflation rates. We considered two other scenarios:- (1) DRI's pessimistic forecast which projects lower real GDP growth and higher inflation and interest rates (referred to here as the "high inflation" scenario); and (2) DRI's optimistic forecast which projects higher real GDP growth and lower inflation and interest rates (referred to here as the "low inflation" scenario). We present our estimates of the Fund's performance under each of these economic scenarios in Exhibit ES-2.

**Exhibit ES-2**

**Summary of MMI Performance by Macroeconomic Scenario**

| | **High Inflation** | **Base Case** | **Low Inflation** |
|---|---|---|---|
| Current Economic Value (FY 1993) | $5,690 million | $4,554 million | $4,239 million |
| Current Capital Ratio (FY 1993) | 1.80% | 1.44% | 1.34% |
| Projected Capital Ratio, (FY 2000) | 4.13% | 3.40% | 3.20% |

Estimated FY 1993 economic values under the different scenarios vary by approximately $1.5 billion, and the estimated FY 1993 capital ratio varies from 1.34 percent to 1.80 percent. We project that under all three scenarios the Fund will significantly exceed the NAHA FY 2000 capital ratio target of 2.0 percent.

**The Potential Effect of Adverse Selection**

Adverse selection occurs when the conditions of insurance (such as price, convenience and cash flow) results in the underwriting of higher-risk loans, while lower-risk loans select lower premiums elsewhere. Because of the dramatic interest rate decline in FY 1992 and FY 1993, FHA experienced an unusual number of prepayments, many of which left FHA. The MMI premium structure is generally more competitive with PMIs for higher-LTV (generally higher-risk) loans, and less competitive for lower-LTV (generally lower-risk) loans, providing a strong incentive for adverse selection. However, sufficient information is not yet available to either prove or disprove the existence of adverse selection with regard to the FY 1992 and FY 1993 prepayments.

We have examined the sensitivity of the FY 1993 Actuarial Review results to two potential effects of the large prepayments. First, we assessed the effect of the possibility that the unusually large prepayments left a higher mix of riskier loans in the existing books of business. Second, we assessed the effect of the possibility that the large refinancings experienced in FY 1992 and FY 1993 substantially lowered the risk profile of the refinanced loans. This lower-risk profile is likely since refinancing lowers the monthly payment burden, while leaving other characteristics unaffected.

In assessing the sensitivity of the results of the FY 1993 Actuarial Review to these effects, we have adjusted the projected conditional claim rates by selected amounts. We have little factual basis on which to select the magnitude of the adjustments. While we have selected adjustments that we believe to be plausible, the adjustments are meant to be primarily illustrative.

The results of our sensitivity analysis show that under all but the most extreme scenarios, the effect on estimated economic value and capital ratios is moderate. Under all scenarios, we project that the Fund will still comfortably exceed the FY 2000 NAHA-mandated capital ratio of 2.00 percent. In the extreme negative scenarios, the Fund would reach the 1.25 percent capital ratio in FY 1995 or 1996, and exceed the 2.00 percent capital ratio in FY 2000.

**The Effect of Data Limitations in Projecting Terminations in the "No Appraisal" Loan Category**

The "No Appriasal" category has grown in the last few years and is now the single largest LTV category, with 31 percent of the origination volume in FY 1993. Unfortunately, we do not have information on the LTV for these loans. Since our econometric models are designed to capture the expected differences in claims between loans with different initial LTV ratios, this growth in the "No Appraisal" category is problematic. If the current distribution of LTV ratios within this category differs markedly from the historical distribution, our estimates of loan performance may be biased. If, for example, the borrowers who pursue streamline refinancings tend on average to have lower levels of home equity and household income than borrowers who do not, the "No Appraisal" category would likely perform worse than projected. Until more accurate data are available regarding the composition of loans within the "No Appraisal" category, we will continue to assume that it will perform in the future as it has in the past. However, to test the sensitivity of the estimated economic value and capital ratio to potential biases in these estimates, we again adjusted the claims rates by selected amounts.

We find that, while affecting the estimated results, any potential bias of this type is unlikely to significantly alter the conclusions of this analysis. In all scenarios, the Fund is still projected to comfortably exceed the FY 2000 capital ratio target of 2.0 percent, and in all but the most extreme negative scenario, the Fund is estimated to have exceeded a capital ratio of 1.25 percent in FY 1993.

# AUDIT REPORT

FEDERAL HOUSING ADMINISTRATION
AUDIT OF FISCAL YEAR 1993
FINANCIAL STATEMENTS

94-FO-131-0002

June 8, 1994

OFFICE OF AUDIT
WASHINGTON, D.C.

audit report
OFFICE OF INSPECTOR GENERAL

| Issue Date | Audit Case Number |
|---|---|
| June 8, 1994 | 94-FO-131-0002 |

TO: Nicolas Retsinas, Assistant Secretary for Housing - Federal Housing Commissioner, H

FROM: James A. Heist, Director, Financial Audits Division, ZAWF

SUBJECT: Audit of the Federal Housing Administration's Fiscal Year 1993 Financial Statements

This report presents the results of Price Waterhouse's audit of the Federal Housing Administration's (FHA) financial statements for the year ended September 30, 1993. In Price Waterhouse's opinion, with which we concur, the financial statements present fairly, in all material respects, FHA's financial position and results of its operations and its cash flows in conformity with generally accepted accounting principles. In addition to the opinion on the financial statements, reports on FHA's internal controls and on its compliance with laws and regulations are provided.

For Fiscal Year 1993, FHA operations resulted in an "excess of revenue over expenses" of $1.6 billion. This increase can be associated with a $1.6 billion decrease in the multifamily loss reserves for Fiscal Year 1993, which was recorded as a credit in the statement of operations. This decrease is attributable to: 1) decreases in the expected claims for projects ranked in the least risky categories because of the improving economy; 2) payment of claims; 3) increases in the amounts expected to be recovered in the ultimate resolution of default claims from the Coinsurance program; and 4) a general improvement in the risk ranking of insured projects as a result of the 1993 portfolio assessment.

## Audit Scope and OMB Audit Requirements

This audit was performed pursuant to the requirements of the Chief Financial Officers (CFO) Act and Office of Management and Budget (OMB) Bulletin 93-06, *Audit Requirements for Federal Financial Statements*. To complete this audit, we contracted with the independent certified public accounting firm of Price Waterhouse. We approved the scope of the audit work, monitored its progress at key points, reviewed Price Waterhouse's working papers, and performed other procedures we deemed necessary. The audit was conducted in accordance with *Government Auditing Standards* and the applicable provisions of OMB Bulletin 93-06.

OMB set forth audit requirements in Bulletin 93-06 that exceed *Government Auditing Standards*, primarily in two areas. These relate to:

- expanding the review of FHA's internal control structure and

- reviewing performance measures contained in FHA's annual report.

To address the first requirement, we engaged Price Waterhouse to expand their review of FHA's internal control structure to meet the additional OMB requirements. The results of this work are incorporated in their report on internal controls. To address the second additional requirement, OIG is performing procedures required by OMB Bulletin 93-06. Because FHA's annual report is not yet complete, our review is ongoing and the results of our review will be reported by us at a later date.

## Results of Price Waterhouse's Audit

In Price Waterhouse's opinion, with which we concur, FHA's financial statements present fairly, in all material respects, its financial position as of September 30, 1993, and the results of its operations and its cash flows for the fiscal year then ended, in conformity with generally accepted accounting principles. In addition to the opinion on FHA's Fiscal Year 1993 financial statements, Price Waterhouse has also reported on FHA's system of internal controls and on its compliance with laws and regulations.

FHA internal control weaknesses are being addressed but still exist

Price Waterhouse's report on internal controls included the same five reportable conditions disclosed in the prior year's audit. The first four reportable conditions are also classified as material weaknesses. The weaknesses are interrelated in that one weakness cannot be effectively addressed without addressing the others. They are:

- HUD must implement its plan to mitigate resource shortages and periodically assess the plan's effectiveness.

- Insured mortgage servicing must place more emphasis on early warning and loss prevention.

- FHA must implement actions to promptly resolve Secretary-held multifamily and single family mortgages.

- Continued emphasis must be placed on improving accounting and financial management systems.

- FHA must perform a complete review of the security and processing controls for all computer systems.

Price Waterhouse's report discusses each of these weaknesses in detail and provides an assessment of actions taken to mitigate the weaknesses.

**Noncompliance with credit reform reporting requirements**

Price Waterhouse's report on compliance with laws and regulations disclosed noncompliance with financial reporting requirements of the Credit Reform Act. In this regard, FHA had commingled pre-fiscal year 1992 cash flows with post fiscal year 1991 cash flows related to up-front insurance premiums received for Single Family mortgages during 1993. This resulted in the credit reform "Liquidating Account" being overstated and the "Financing Account" being understated by $500 million. Price Waterhouse's report discusses this issue in detail and recommends system improvements to correct this weakness.

## Recommendations and Follow-up on Prior Audits

In audit reports on FHA's prior years' financial statements, various recommendations had been presented to address FHA's internal control weaknesses. While FHA has taken certain actions to address these recommendations, corrective actions are not complete. In accordance with the Department's Audits Management System, we will continue to track the resolution of these prior years' audit recommendations.

Price Waterhouse reported a new recommendation in the report on compliance with laws and regulations. We are restating and numbering this recommendation as follows to facilitate its tracking in the Department's Automated Audits Management System.

1.a. Make appropriate systems enhancements to track cash flows relating to the MMI Fund Financing and Liquidating accounts in accordance with the requirements of the Credit Reform Act.

## Comments of FHA Officials

On February 5, 1994 we provided a draft of Price Waterhouse's report on internal controls to FHA officials for their review and comment. In response to their comments, a revised draft was presented to FHA officials on May 15, 1994. Draft reports on FHA's financial statements and on its compliance with laws and regulations were provided to FHA officials on May 31, 1994. FHA officials generally agreed with the findings and recommendations and their comments were considered in developing the final version of this report.

During the course of the audit, Price Waterhouse also identified several matters which, although not material to the financial statements, are being communicated to us and FHA separately. We appreciate the courtesies and cooperation extended to the Price Waterhouse and OIG audit staff during the conduct of the audit.

# Table of Contents

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*Price Waterhouse*

**REPORT OF INDEPENDENT ACCOUNTANTS**

To the Inspector General,
U.S. Department of Housing and Urban Development

We have audited the accompanying consolidated statements of financial position of the Federal Housing Administration (FHA), an agency operated by the Department of Housing and Urban Development (HUD), as of September 30, 1993 and 1992, and the related consolidated statements of operations, government equity (deficiency), and of cash flows for the years then ended. These financial statements are the responsibility of FHA's management. Our responsibility is to express an opinion on these financial statements based on our audits.

Except as explained in the following paragraph, we conducted our audits in accordance with generally accepted auditing standards, and *Government Auditing Standards*, issued by the Comptroller General of the United States. These standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion. In addition, except for portions of the Bulletin that relate to the Federal Managers' Financial Integrity Act of 1982, and the review of performance measures which was performed by HUD's Office of Inspector General, we conducted our audits in accordance with Office of Management and Budget (OMB) Bulletin 93-06, *Audit Requirements for Federal Financial Statements*.

In our report dated April 16, 1993, we did not express an opinion on FHA's statements of operations, of government equity (deficiency), and of cash flows for the year ended September 30, 1992. This was because, prior to September 30, 1992, FHA was unable to determine whether its multifamily loss reserves were sufficient to cover probable loan defaults, or to determine the fiscal year in which events giving rise to the loss reserve first occurred. As a result, when FHA completed its first multifamily loss reserve analysis as of September 30, 1992, the entire adjustment, amounting to $6.4 billion, was recorded in FHA's 1992 statement of operations, notwithstanding that some of these losses may have been attributable to earlier years. FHA's inability to reasonably estimate the multifamily loss reserves resulted primarily from its lack of complete and accurate financial and operational information about individual multifamily loans, and the lack of a systemic, internal process in which loans are periodically assessed according to their credit risk. For the two most recent fiscal years, management of

FHA initiated special projects in which financial information about certain loans was obtained, loans were assessed and ranked according to their risk, and a multifamily loss reserve was calculated and recorded. While these special projects served as a basis for determining a loss reserve on insured multifamily loans primarily for financial reporting purposes, they are temporary in nature and have not corrected the material internal control weaknesses with respect to multifamily loan information, risk assessment, and automated systems included in our Report on Internal Controls.

As discussed in Note 6 to the financial statements, management's 1993 assessment of the Multifamily insured loan portfolio resulted in a decrease to the loss reserve of $1.6 billion, which was recorded as a credit in the statement of operations for the year ended September 30, 1993. This decrease is attributable to: (1) decreases in the expected claims for projects ranked in the least risky categories in light of improvements in the economy; (2) payment of claims: (3) increases in the amounts expected to be recovered in the ultimate resolution of default claims from the Coinsurance program; and (4) a general improvement in the risk ranking of insured projects as a result of the 1993 portfolio assessment. Management of FHA believes the multifamily loss reserve of $10.3 billion recorded in the September 30, 1993 statement of financial position is sufficient to cover losses on the insured multifamily portfolio

Because of the matter discussed in the third paragraph, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the consolidated statements of operations, government equity (deficiency) and cash flows for the year ended September 30, 1992.

In our opinion, the consolidated statements of financial position of the Federal Housing Administration as of September 30, 1993 and 1992, and the related consolidated statements of operations, government equity (deficiency), and cash flows for the year ended September 30, 1993, present fairly, in all material respects, the financial position of the Federal Housing Administration as of September 30, 1993 and 1992, and the results of its operations, its government equity (deficiency), and its cash flows for the year ended September 30, 1993, in conformity with generally accepted accounting principles.

Our audit was made for the purpose of forming an opinion on the consolidated financial statements taken as a whole. The consolidating information is presented for purposes of additional analysis of the consolidated financial statements rather than to present the financial position, results of operations, government equity (deficiency), and cash flows of the individual budgetary funds through which FHA operates its activities. Accordingly, we do not express an opinion on the financial position, results of operations, government equity (deficiency), and cash flows of the individual funds. However, the consolidating information has been subjected to the auditing procedures applied in the audit of the consolidated financial statements. For the reasons described above, we are unable to, and do not, express an opinion on whether the consolidating statements of operations, government equity (deficiency), and cash flows for the years ended September 30, 1992 are fairly stated, in all material respects, in relation to the consolidated financial statements taken as a whole. In our opinion, the consolidating statements of financial position as of September 30, 1993 and 1992 and the related statements of operations, of government equity (deficiency), and of cash flows for the year ended September 30, 1993 are fairly stated, in all material respects, in relation to the consolidated financial statements taken as a whole.

Price Waterhouse

Washington, D.C.
May 31, 1994

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Price Waterhouse

## REPORT OF INDEPENDENT ACCOUNTANTS ON INTERNAL CONTROLS

To the Inspector General,
U.S. Department of Housing and Urban Development

We have audited the consolidated financial statements of the Federal Housing Administration (FHA), an agency operated by the Department of Housing and Urban Development (HUD), as of and for the year ended September 30, 1993, and have issued our report thereon dated May 31, 1994. We conducted our audit in accordance with generally accepted auditing standards, and *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. In addition, except for the portions of the Bulletin that relate to the Federal Managers' Financial Integrity Act of 1982, and the review of performance measures which was performed by HUD's Office of Inspector General, we conducted our audit in accordance with Office of Management and Budget (OMB) Bulletin 93-06, *Audit Requirements of Federal Financial Statements*.

In planning and performing our audit of FHA's financial statements for the year ended September 30, 1993, we considered its internal control structure in order to determine our auditing procedures for the purpose of expressing an opinion on the financial statements. With respect to those controls that are material in relation to the consolidated financial statements we determined whether FHA has an internal control structure that provides reasonable assurance of achieving the internal control objectives described in the following paragraph in accordance with OMB Bulletin 93-06.

The management of FHA is responsible for establishing and maintaining an internal control structure. In fulfilling this responsibility, estimates and judgments are required to assess the expected benefits and related costs of internal control policies and procedures. The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that: (1) transactions are properly recorded and accounted for to permit the preparation of reliable financial statements and to maintain accountability over assets; (2) funds, property, and other assets are safeguarded from loss from unauthorized use or disposition; and (3) transactions, including those related to obligations and costs, are executed in compliance with laws and regulations that could have a direct and material effect on the financial statements. Because of inherent limitations in any internal control structure, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

For the purpose of this report, we have classified the significant policies and procedures relative to FHA's internal control structure in the following categories:

- General ledger and Treasury operations
- Financial Reporting
- Insurance in Force and Endorsement
- Premiums, Premium Refunds, and Distributive Shares
- Risk Monitoring
- Claims Processing
- Foreclosed Property Held for Sale
- Mortgage Notes Receivable
- Field Office Operations
- Administration and Other

For all the relevant categories listed above, we obtained an understanding of the design of relevant policies and procedures, determined whether they have been placed in operation, assessed control risk, and tested those controls which have been properly designed and placed in operation and are material to the consolidated financial statements.

Our study and evaluation disclosed the following conditions in the internal control structure of FHA in effect at September 30, 1993, which, in our opinion, result in more than a relatively low risk that errors or irregularities in amounts that would be material in relation to the consolidated financial statements may occur and not be detected within a timely period

We noted certain matters in the internal control structure and its operation that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect the entity's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. Certain of the reportable conditions were also considered to be material weaknesses.

A material weakness is a reportable condition in which the design or operation of specific elements of the internal control structure do not reduce to a relatively low level the risk that errors or irregularities, in amounts that would be material in relation to the financial statements being audited, may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

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To address the material weaknesses identified in our prior year audits of FHA, HUD management developed a plan which analyzes FHA's major problems, identifies their root causes, and sets corrective action steps. As part of this internal control report, we have included, in summary fashion, the actions HUD plans to take and have provided our assessment of them. We believe this plan is a comprehensive and serious effort on the part of HUD's management to address problems that have plagued FHA for many years

Implementation of its action steps would, in our opinion, do much to correct long-standing problems, and more importantly, conserve scarce resources.

That said, it must be emphasized that HUD's prior inability to fully correct FHA's problems was due mainly to incomplete or spotty follow-through of planned actions, rather than from the lack of a good plan. Even when there was consensus about the problems and the solutions, corrective action was often slow or non-existent. Accordingly, our internal control report will also endeavor to measure HUD's progress toward implementing its planned corrective actions.

It is equally important, however, to stress that the lack of follow-through has often not been the fault of HUD's management or staff. For example, management has made efforts to re-invest resources in HUD's people and computer systems -- areas where such an investment is sorely needed -- and to remove barriers to addressing and fixing troubled loans, only to be frustrated by budgetary or legislative constraints. Similarly, efforts to re-align and/or consolidate FHA's operating structure to make it more efficient and accountable were often unsuccessful because of lost momentum or organizational resistance. Continued attention to difficult solutions by senior HUD management will be an essential ingredient to their ultimate success. An equally essential ingredient will be management's ability to become more resourceful and innovative in formulating corrective actions if the initial action becomes infeasible.

We have in prior years expressed concern about the adequacy of FHA's staffing -- both in terms of numbers and depth of expertise. The recent build-up of defaulted single and multifamily notes assigned to FHA, and the prospect that many insured multifamily notes will also require significant staff attention to prevent further assignments, heighten this concern. Furthermore, because it is apparent that hiring and training additional staff is simply not an option in today's tight budgetary environment, HUD's need to concentrate staff on dealing with a sizable inventory of troubled loans may detract from its efforts to provide sound housing credit, manage credit risk, and prevent unnecessary losses.

As will be discussed later in this report, private institutions who provide credits of similar size and complexity to those provided through FHA's multifamily programs, typically dedicate considerably more resources to managing them, especially if the loans begin to show problems. They do this not merely because financial regulators would question the soundness of doing otherwise, but also because it makes good business sense. For if a loss from the default of a large loan can be prevented with more staff attention, the cost of more staff is immediately offset. This being the case, it seems scarcely possible to justify staff reductions or shortages at FHA on cost/benefit grounds. In any event, it is important to understand that the corrective actions one might take in an ideal set of circumstances might not be feasible here and that HUD's corrective actions for FHA must be evaluated bearing this in mind.

We have classified weaknesses in the internal control structure into four major categories to facilitate a targeted approach to their eventual correction. These four categories are inter-related in that one weakness cannot be effectively addressed without addressing the others. They can be summarized as follows:

- *The need to address weaknesses caused by lack of staff and administrative resources.* The lack of resources, both personnel and funds for such items as systems maintenance and development, prevents HUD from placing adequate resources on loss mitigation functions, properly managing troubled assets, and quickly implementing new automated systems for FHA.

- *The need to place more emphasis on early warning and loss prevention.* FHA needs to focus more attention on reducing the frequency and loss severity of defaults of insured mortgages by improving their efforts to identify and react to troubled mortgages before they become defaults. For such a program to be effective, field and headquarters staff must be adequately trained and available to execute it, and systems need to be in place both to provide needed information and to monitor progress and dollar savings.

- *The need to resolve defaulted Secretary-held single family and multifamily loans.* The portfolio of Secretary-held single and multifamily notes has increased dramatically during the last 10 years. Servicing and managing defaulted loans assigned to FHA requires a considerable amount of staff resources. This staff intensive effort takes away from the monitoring of insured mortgages, consequently resulting in additional claim payments and therefore, Secretary-held mortgages.

- *The need to improve automated systems.* Some of FHA's systems either do not provide needed management information or do not provide reliable information. The lack of modern systems and other tools make monitoring less productive and staff usage less efficient.

The remainder of this report discusses each of these weaknesses in more detail, summarizes corrective actions the Department has taken, or plans to undertake in the future, to mitigate the weaknesses to the maximum extent possible in the current restrictive budgetary environment, and provides our assessment as to the ultimate effectiveness of the planned corrective actions in mitigating the weaknesses. We have excluded from our discussion any planned corrective actions which we believe, in agreement with HUD management, will not effectively or substantially address the underlying weakness.

Augmenting the narrative discussion of HUD's plans to correct each weakness, we have presented a chart which exhibits our assessment as to HUD's progress toward ultimately correcting the weakness. As discussed above, HUD's prior inability to fully correct FHA's problems has been due mainly to incomplete or spotty follow-through of planned actions, rather than from the lack of a good plan. With these graphs, during the next few years, we will chart HUD's progress toward effectively correcting the weaknesses. These graphs are intended to place more emphasis on implementing effective actions which *correct or mitigate* the weakness than on plans to potentially correct the weakness.

In providing our assessment as to the current status of the corrective actions, the "Plan Only" line on the graph will be met when HUD has developed a comprehensive action plan which identifies specific action steps, and associated time-tables, for the ultimate completion of the actions. A "plan to develop a plan in the future" does not meet this definition. The "Some Implementation" line will be met when HUD has made substantial progress in implementing actions which result in *actual progress being made in correcting or mitigating the weaknesses*. HUD will meet the "Well in Progress" goal when they are approximately 50% of the way to correcting the weakness. A "Substantially Complete" level will be reached when approximately 90% of the planned actions have been implemented. HUD will meet the "Complete and Verified" level when virtually all actions have been completed, and the corrective actions have *mitigated the weaknesses as much as possible*.

*MATERIAL WEAKNESSES*

**HUD MUST IMPLEMENT ITS PLAN TO MITIGATE RESOURCE SHORTAGES AND PERIODICALLY ASSESS THE PLAN'S EFFECTIVENESS**

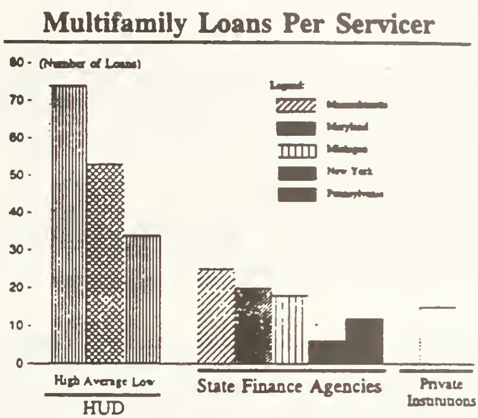
For a number of years, we, along with HUD's Inspector General and HUD staff itself, have expressed concern about the adequacy of staffing and funds to effectively perform fundamental FHA activities, such as monitoring of the insured portfolio, servicing Secretary-held mortgages, and managing foreclosed properties. Our audit work indicated that HUD personnel in these areas were not performing many of these critical functions as diligently or as expeditiously as they should, not as a result of complacency, but rather because they lacked the resources to do so.

In addition, we noted that the manner in which FHA is organized is inefficient, and probably exacerbates the staffing and resource problems. In this regard, HUD is attempting to consolidate some of its field operations into fewer locations and establish more direct accountability between the Federal Housing Commissioner and the field operations

Ideally, FHA should have the ability to use a sufficient amount of its own resources if it can justify that such a usage will be cost beneficial. However, unlike private institutions or government-sponsored enterprises involved in housing credit, HUD management does not have the authority to hire more staff or invest more resources in automated tools or staff training, even if its business expands or its workload increases. The Federal budget process limits the amount of staff and resources HUD can use to execute FHA programs, generally without regard to work load or risk factors HUD has been unable to obtain a substantial increase in either the number or experience level of staff, nor an increase in the amount of funds necessary to properly operate the FHA programs. Ceilings or other limitations imposed on full-time equivalents or administrative expenses restrict FHA's ability to perform critical credit and asset management functions. We believe resource restrictions that increase the risk of borrower default or the cost of disposing of assets are fundamentally at odds with the concept of actuarial soundness and sound credit management.

Currently, HUD's most critical staffing needs are in the multifamily insured and Secretary-held notes servicing area, and in the single family Secretary-held note servicing area. It is useful to assess the number of HUD staff assigned to these critical FHA areas in light of benchmarks for other credit providers. The fact that Federal regulators review the adequacy of staff resources as a factor in assessing a private credit institution's safety and soundness makes this comparison even more relevant. When comparing HUD to other credit providers, one must bear in mind that there are differences in the nature of their operations. One important difference is that HUD generally takes on more credit risk than private or state-run credit institutions, and thus its portfolio will typically have a higher proportion of troubled credits at any given time. Since troubled credits require more frequent attention and generally must be handled with more care, private credit institutions typically assign more staff to them. Thus, one would expect HUD to have more staff assigned to FHA's critical loan servicing functions. However, as can be seen in the following chart (Chart 1), even though the mortgages in the FHA insured and Secretary-held portfolios are riskier than conventional mortgages, the number of notes serviced by HUD field staff is considerably higher than industry norms.

Chart 1




On average, a HUD employee involved in multifamily loan management services over 50 loans; an employee at the HUD field office with the highest loan-to-servicer ratio services approximately 73 notes. This compares to the state housing finance agencies average of approximately 20 loans per servicer and the private institutions average of 15 loans per servicer. Even the HUD field office with the lowest loan-to-servicer ratio has a ratio which is nearly twice that of the state agencies and private credit institutions.

During fiscal year 1993, HUD requested that OMB temporarily increase the staffing ceiling set for the Department by 400 staff for fiscal years 1994 and 1995. This increase was targeted to assist in resolving the portfolio of multifamily Secretary-held mortgages and properly servicing those mortgages still insured, so as to mitigate any potential losses to the FHA Fund. This request was denied. However, FHA has received approval from OMB to temporarily hire 100 staff, for fiscal year 1994 only, to assist in improving the activities in the multifamily area.

Because HUD has been unable to obtain the necessary levels of additional staff and fund resources to properly manage the FHA programs as currently designed, HUD has begun to examine alternatives to restructure FHA's programs and operations so as to curtail or eliminate staff-intensive activities and free-up staff to concentrate on the more critical functions. Many of the corrective actions for resolving these weaknesses will span many years. HUD has planned or executed the following actions to reduce the present work-load of staff:

**HUD Action Plan to Address the Resource Problem:**

*Multifamily Actions:*

During the last 12 months, the Office of Multifamily Housing has analyzed the problems caused by resource shortages and identified solutions available which would make a substantial improvement in the effectiveness of their operations without an increase in staff resources. Based on this effort, the multifamily area has identified the following action plan:

- *Reduce staff workloads* -- Currently, the field office staff are not able to perform the level of servicing required by their servicing handbooks. During the most recent 8 months, the Office of Multifamily Housing has spent significant time reviewing and analyzing the activities performed by field office staff with the intent of reducing the amount of non-critical work performed by the field staff. These efforts have focused on:

  -- identifying critical functions that HUD field staff must perform.
  -- identifying functions which are critical to be performed but do not need to be performed by HUD staff. HUD has already contracted with a firm to provide services to enter financial statement data into the monitoring system for a number of multifamily insured projects.
  -- obtaining mortgagee cooperation to perform various asset management duties currently performed by HUD but which are not functions which HUD staff need to perform.
  -- providing the field office staff with a more flexible servicing approach to allow field office personnel to use their judgement while performing servicing duties.

- *Improve the utilization of existing staff* -- Currently, the existing staff are not used in the most efficient manner possible. Some field offices have larger more complicated portfolios than others; the computer systems developed to manage the insured portfolio have not provided a method for the targeting of resources to those projects which require immediate attention; and, in some cases, the field offices have not been provided with the necessary vehicles to improve the financial condition of the insured portfolio. To improve the efficiency and usage of available staff, the Office of Multifamily Housing intends to:

- equalize workloads among the field offices by analyzing current workload levels and identifying those offices with abnormal loan to servicer ratios. This analysis has already been performed and implementation is on hold pending the Departmental reorganization of the field offices.
- retain experienced staff by increasing the pay levels for the more experienced staff, and by increasing the loss mitigation training for all servicers. Steps are underway to implement both of these actions, with completion of training for all field office staff estimated by the end of 1994.
- provide data systems which assist the field office staff in performing their duties by developing a system which will be used as a tracking, targeting, monitoring, and analytical tool.
- provide tools to assure financially and physically sound properties by improving the establishment of Section 8 rents and modifying the Section 8 and Regulatory Agreements to develop practical and workable enforcement tools; streamlining or eliminating existing requirements; and, improving supervisory monitoring of the quality of the Loan Servicers monitoring reviews.

The Office of Multifamily Housing expects that a more definitive "strategic plan" will be delivered within the coming months which will precisely address the specific steps which the multifamily housing group will implement to address this weakness.

*Single Family Actions:*

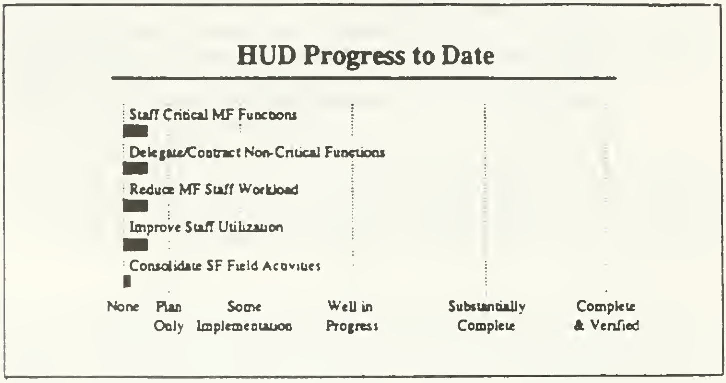
The single family Secretary-held mortgage note servicing area exhibits the same weaknesses as the multifamily area -- too much work to perform with too few staff. However, the long term solutions to the staffing shortages in the single family area will rely on an analysis currently being performed on the success/failure of the note assignment program itself. This report is expected to be completed in early calendar year 1995. These analyses are discussed in more detail in the following material weakness. In the interim, the single family area plans to improve servicing of the portfolio by consolidating servicing activities into fewer locations to obtain an economy of scale, and ultimately assessing whether contracting out all or parts of the servicing activities would be a viable alternative.

*Price Waterhouse Assessment of Planned and Completed Actions:*

In light of the fact that HUD was unsuccessful in obtaining a significant number of additional staff, we consider this action plan a reasonable one. This notwithstanding, we are skeptical of HUD's ability to manage its present workload in a well-controlled manner given its present high workload-to-staff ratios. In our prior year report, we recommended that, if additional staff resources were not forthcoming, HUD consider structural changes to FHA to reduce or eliminate staff intensive functions. These structural changes could include: (1) consolidating certain field office functions into fewer locations to obtain an economies of scale, thus reducing the overall burden on staff; or (2) modifying the single family claim payment structure to discontinue the current mortgage assignment program which has become a labor-intensive and difficult program to operate effectively, and replacing it with a program which will be more effective in keeping home-owners in their homes, while also reducing the labor intensive efforts required by the current program. We understand that HUD does not consider these changes to be feasible in all cases. Nevertheless, if after significant implementation of the action plan it is found that problems in loan servicing and risk management persist, then HUD may have to re-consider structural changes.

The chart below (Chart 2) is a depiction, by major action areas, of our assessment of HUD's progress toward implementation of actions to mitigate resource shortages:

Chart 2



**INSURED MORTGAGE SERVICING MUST PLACE MORE EMPHASIS ON EARLY WARNING AND LOSS PREVENTION**

In prior years, we recommended that HUD make its monitoring of insured mortgages more proactive and preventive in nature, with the ultimate goal of reducing mortgage defaults and consequently claims and losses to the FHA Fund. Monitoring can essentially be thought of as actions to monitor those who endorse FHA mortgage insurance (mortgagees) and monitoring of the borrowers (mortgagors) themselves. Preventing note assignments and property conveyances would also ease FHA's staff burden when excessive numbers of mortgages and properties must be managed, serviced and sold. We recommended that both the multifamily and single family areas: (1) improve their ability to identify and classify potentially problem insured loans and mortgagees; (2) place more emphasis on working with mortgagees to cure defaults and delinquencies before they become claims; and (3) develop accountability tools that will allow management throughout FHA, but most particularly senior management officials, to monitor the success of default and loss prevention efforts. In making these recommendations, we emphasized that the problems were more critical and the potential losses were greater in the multifamily area. Our most recent audit indicates that this continues to be the case.

*Multifamily:*

In previous years, we reported the need for HUD to improve its ability to identify problem multifamily mortgages through the development of an effective early warning system, and to subsequently develop written action plans for loans classified in troubled categories that define actions FHA would take to prevent claim payments. The process currently relies heavily on the field staff to identify problem mortgages, and because of the workload, resource, and training problems discussed above, the field staff are not always able to identify problem loans Consequently, the staff do not always identify weaknesses or take steps to mitigate losses to the FHA Fund. We recommended that HUD: (1) implement an automated system to gather loan-by-loan financial and operational data; (2) make the loan risk assessment a permanent, on-going process which is used by the field office to target servicing efforts to the more risky mortgages; (3) develop a reporting mechanism for senior management wherein the loan assessments are periodically summarized and action steps for troubled loans are developed for the field offices to execute; and (4) develop a training program for field staff so they can effectively execute these action steps. Developing the means to continually risk-rank the insured portfolio would allow HUD to target its limited resources to those projects that pose the greatest risk to the FHA Fund. In addition, having detailed and accurate financial and operational information about each loan would improve decisions on what methods should be used (e.g. obtain additional support through other HUD programs, restructure the loan, or initiate foreclosure) to assist the project in becoming current and ultimately minimize the losses to FHA.

For the second year, FHA completed a process which re-constructed financial data for approximately 12% of its insured multifamily loans, including many of its large and troubled loans, and which established loss reserves for loans in troubled categories. Importantly, this critical process was performed by HUD staff, and as a result, the beginnings of an ongoing risk-evaluation function have been established. The next steps will be to refine and expand this process such that risk evaluation can take place more timely and more frequently.

*Single Family:*

The single family area has experienced some of the same problems as the multifamily area although to a much lesser degree. Unlike the multifamily area, Single Family has a quality control mechanism independent of the field offices -- the Mortgagee Monitoring Division (MMD). Also, although insured single-family loans are more numerous, their structure is simpler and more standardized, making computerized monitoring via statistics and trends more viable. In previous years, we reported the need for management to improve the monitoring of its mortgagees by: (1) addressing the possibility of implementing a program that would allow FHA to advance payments in lieu of taking a note assignment and making a full claim payment; (2) continuing to improve the accuracy in its single family default monitoring system which is partially used to target reviews of poor performing mortgagees; and, (3) increasing the MMD staff to a level sufficient to allow the MMD to expand its reviews to include mortgagees with poor cure rates.

HUD Action Plan to Improve Monitoring and Early Warning:

*Multifamily:*

- *Implement a Multifamily Early Warning System* -- HUD is beginning to address the automated system needs for the Multifamily area. A project manager has been assigned the task of completing an Information Systems Plan for the Multifamily program area. This plan will include all aspects of Multifamily operations and will include the insured project servicing needs which includes early warning for use by the field office staff. HUD is currently developing the Multifamily National System (MNS) as an interim system which will be used to monitor and service insured multifamily projects. A module is being developed which will risk-rank all projects based on certain financial and operational aspects. Using this MNS ranking, the field offices will then target problem projects for review. Implementation of the MNS module which will automatically risk-rank each insured project is scheduled for late-calendar year 1994. The development of senior-level management reports is to be developed once the risk-ranking module is implemented.

- *Improve the use of tools to limit losses* -- In addition to having the hardware and software to identify troubled and potentially troubled projects, HUD management has identified the following changes in legislative or regulatory areas which will assist HUD in limiting losses to the FHA Fund:

    - *Modify regulations which currently serve as a deterrent to refinancing* -- A number of current regulations serve as a deterrent to refinancing many insured multifamily mortgages thereby not allowing mortgagors to take advantage of the current low interest rates and reduce their debt service payments. Reducing the debt service payments of multifamily projects will then decrease the risk of default of the mortgage. HUD has already waived a number of regulatory impediments for un-subsidized mortgagors to use refinancings. HUD has established working groups to identify improvements to also allow subsidized projects and bond refunders to take advantage of the current low interest rates. Completion of these actions are slated for mid-calendar year 1994.

-- *Revise the partial payment of claim policy* -- HUD intends to enhance the usefulness of partial payments of claims in a number of cases to allow for a payment of a claim without the assignment of an entire mortgage to HUD. In these cases, a partial claim payment will be made for the delinquency of an insured mortgage which HUD would then hold as a second mortgage which would be re-paid by the mortgagor as the project's cash flows allow. This procedure would dictate that the mortgagee retain and service the mortgage; thus enabling HUD to avoid servicing the entire mortgage. Completion of these actions are slated for mid-calendar year 1994.

-- *Propose legislation* -- HUD has identified a number of areas for which legislation has been proposed which will: allow HUD to fund project needs (Flexible Subsidy and Loan Management Set Aside) based on Comprehensive Needs Assessments; remove the mandatory requirement for owner contribution under the Flexible Subsidy program; and allow the Commissioner to automatically process partial payments of claims on new loans. The legislation has been submitted to Congress. Completion of these actions are slated for mid-calendar year 1995 assuming Congress passes the legislation.

*Single Family:*

- *Assess the success and cost of the current note assignment program* -- One of the major impediments HUD has had in developing alternatives to the present note assignment program has been the lack of a complete success/failure and cost/benefit analysis of the note assignment program as it is currently designed and operated. Ideally, as an insurance company, FHA should have the capability to pay claims which do not result in an assignment of a mortgage note or the conveyance of a property. Once a note or property enters the Secretary-held inventory it requires a large amount of staff intensive servicing and selling actions which HUD has not been able to properly provide for a number of years. However, we understand that current legal and legislative requirements have limited the ability of HUD to develop modifications to the current program which would reduce the staff intensive, and often unsuccessful, activities which are now performed. HUD has contracted to have a complete analysis of the success of the program as it has been designed and operated during the last 10 years. Only when this study is complete, will HUD be able to assess the long-term outlook for the operations of the single family program. This study is not expected to be completed until early 1995.

- *Identify alternatives to foreclosure* -- HUD has already performed a study of the current industry-wide programs that assist troubled borrowers avoid property foreclosure, and the options available for the Department to adopt some of these programs as an addition to, or a substitute for, the current assignment and conveyance programs. Once the true historical success rate for the assignment program is determined by the analysis summarized above, the Office of Single Family Housing will be able to develop an effective assistance program which will allow delinquent mortgagors to cure their delinquency as soon as possible and remain in their homes.

- *Implement the pre-foreclosure sale program on a nation-wide basis* -- As discussed above, ideally, when it is not feasible for the mortgagor to remain in the property FHA should have the capability to pay claims which do not result in an assignment of the mortgage note or the conveyance of the property. During the past two years, FHA has been performing a demonstration project in five field offices whereby a delinquent insured mortgagor sells his/her home and the mortgagee submits a claim for the difference between the unpaid principal balance plus accrued delinquencies and the amount received from the property sale. Under this program, FHA does not receive a property or an assigned note. HUD is currently performing an evaluation of the success of this demonstration project and intends to implement the program on a nation-wide basis if the program is determined to have been a success.

- *Improve the data quality of the delinquency information in the Single Family Default Monitoring System (SFDMS)* -- A key monitoring device in the single family area is the SFDMS. This system tracks and monitors delinquency information at a mortgagee/servicer level and allows FHA to identify those mortgagees/servicers who have excessive default rates. HUD then performs on-site reviews of their servicing procedures to ensure that they are meeting HUD standards. During fiscal year 1993, HUD implemented a self-curtailment of interest program whereby mortgagees/servicers limit the amount of interest they receive on claim payment if they do not report the delinquency to HUD through the SFDMS. Compliance with the self-curtailment initiative is being monitored by HUD through its post-claim review process. Automated curtailment of interest by HUD during the claim process is planned for late calendar year 1996.

  During fiscal year 1993, HUD also implemented an expanded reporting process whereby mortgagees/servicers also report data to the SFDMS for those cases where the mortgagor has become current, or "cured" the delinquency. HUD now also has the ability to target monitoring reviews to those mortgagees which have below-average "cure" rates for the mortgages they service. The desire is to improve mortgagee servicing through these reviews, and consequently reduce the number of claim payments made by FHA.

- *Supplement the Mortgagee Monitoring Division (MMD) staff in performing on-site reviews of insuring/servicing mortgagees* -- During our previous audits we noted that the number of on-site servicer reviews performed by the MMD had decreased due to a decline in the number of staff in the Division. Consequently the deterrent effect of performing the reviews could be limited. During fiscal year 1993, MMD nired a contractor to supplement HUD staff in performing on-site monitoring, almost doubling the number of reviews that would have been performed. This increased monitoring should improve mortgagee/servicer compliance with HUD regulations and improve the servicing of the insured portfolio, consequently reducing the number of claim payments made by FHA.

*Price Waterhouse Assessment of Planned and Completed Actions:*

HUD's planned efforts to mitigate this weakness as described above will improve their ability to mitigate losses to the FHA Fund. Improving the early warning capabilities and the loss mitigation actions of FHA are essential to ensuring that the FHA programs are operated in the most proficient manner possible.

Senior management should ensure that the corrective actions are executed completely and expeditiously in all areas. In the multifamily area, special attention should be given to

- ensuring that the risk-ranking module of a national system is developed as quickly as possible to provide the field office staff with a vehicle which allows them to target their limited resources to those projects which require increased loss mitigation efforts

- developing senior-level reports for use in monitoring the effectiveness of the field offices' execution of the loss mitigation efforts. These reports should be compared to goals provided for each field office.

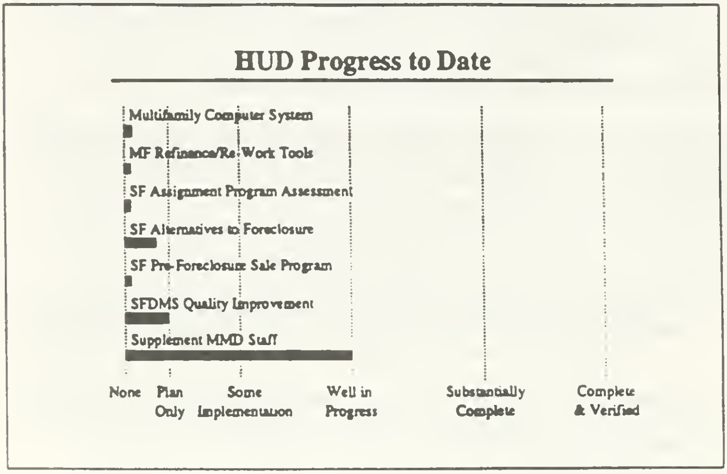
In the single family area, special attention should be given to:

- ensuring that the analysis of the success/failure rate of the current assignment program meets its goal of providing a base-line from which future decisions can be made for the development of an effective single family assistance program.

- ensuring that the SFDMS, MMD, and the Mortgagee Review Board continue to be visible and effective tools for monitoring the originating and servicing lenders who participate in the FHA single family programs.

The chart below (Chart 3) is a depiction, by major action area, of our assessment of HUD's progress toward implementation of actions to improve their mitigation activities:

Chart 3



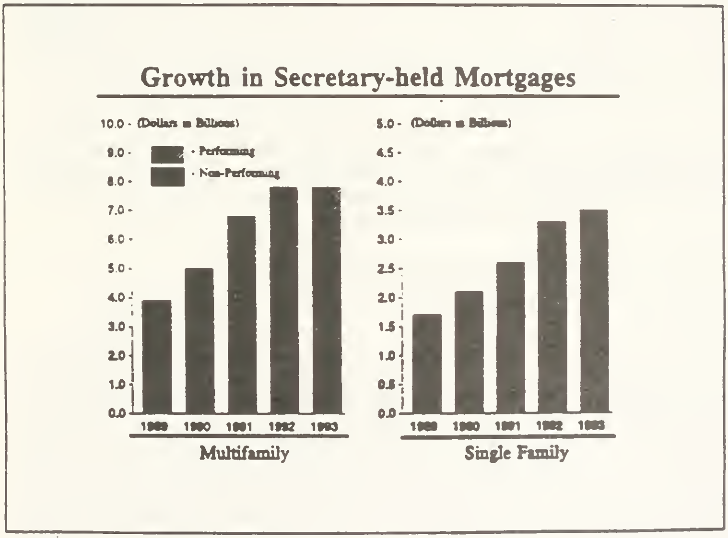

*Additional Recommendations:*

We continue to believe that assigning responsibility for periodic on-site monitoring of the servicers of insured multifamily mortgages to MMD is needed and we recommend it be adopted. Reviews of multifamily servicers are not currently performed unless referrals are made by the field office staff to MMD or the Office of Inspector General (OIG). During our review, we noted a number of servicers who had a large number of projects currently in default; however, there is no HUD staff member responsible for the overall monitoring of these servicers. The MMD staff are knowledgeable and experienced in performing these types of servicer reviews, targeting servicers for review, and referring exception cases to the Mortgagee Review Board. MMD should be assigned the responsibility to review the servicing of the larger, national servicers who cross-cut a number of field offices. An increase in staff or contract fees would also be necessary when increasing the level of reviews performed by MMD.

## FHA MUST IMPLEMENT ACTIONS TO PROMPTLY RESOLVE SECRETARY-HELD MULTIFAMILY AND SINGLE FAMILY MORTGAGES

Last year we reported that FHA needed to quickly resolve, either through sale, restructuring, workout, or foreclosure, its growing portfolio of single and multifamily Secretary-held notes. This issue grew in prominence over the years because, coupled with a squeeze on resources, the growth in defaulted loans poses the danger of detracting resources from other critical areas, thus weakening FHA's overall internal control structure. During our 1993 audit, we noted that: (1) the number of assigned multifamily and single family assigned notes continued to increase; (2) the servicing of these portfolios has been deficient due in part to their size and growth; and, (3) the effort required to service assigned notes, even though it has been deficient, has drawn resources away from servicing insured mortgages. This latter problem increases the risk that still more insured mortgages may default and be assigned to HUD. The following chart (Chart 4) depicts the large growth in multifamily and single family performing and non-performing mortgages during the last 5 years.

Chart 4




Observe in the above chart that there has been a pronounced build-up of defaulted multifamily notes assigned to FHA. As of September 30, 1993, FHA had $7.8 billion in assigned multifamily notes of which $6.0 billion or 77% were non-performing. A large number of non-performing notes is particularly significant because they require even more servicing attention and present a significant financial risk to FHA. Making this build-up of defaulted assets even more serious is that HUD has had statutory and budgetary impediments that have prevented it from foreclosing on the mortgaged property even in those cases where the economics underlying the note make other plans impractical or infeasible. For example, if HUD decides to foreclose on a mortgaged multifamily property it is required by statute to provide additional rental subsidies. However, since insufficient funds are appropriated to HUD to actually pay this subsidy, foreclosure is indefinitely delayed and poor loans languish in the FHA portfolio. Restrictions such as these not only tie HUD's hands in dealing with troubled or flawed mortgages and contribute to the overall deterioration of the portfolio of assigned mortgages, but they also send an extremely poor message industry-wide that HUD will not foreclose even when it is appropriate and justifiable to do so.

There has also been a considerable build-up in single family assigned mortgages. We understand that the build-up of these mortgages is primarily due to difficult economic conditions which substantially increased the number of "temporary hardship cases" and thus the number of single family loans assigned to FHA. Further, the number of loans assigned, as a percentage of total claims, has increased from approximately 11 percent in 1988 to 20 percent in 1993. Managing and servicing FHA's portfolio of single family loans is particularly difficult because the vast majority of loans are either in default or under a forbearance agreement which requires a high level of servicing effort. Furthermore, we also noted a number of instances where servicing was not being properly performed.

In last year's report, we recommended that HUD: (1) develop strategies and time-frames for returning delinquent notes to current status; (2) attempt to sell, or otherwise place current or delinquent notes back into the private sector; (3) consolidate note servicing into fewer locations and dedicate staff solely to loan servicing and reducing the portfolio; and, (4) periodically summarize, in writing, success against planned actions

HUD Action Plan to Reduce Assigned Mortgages:

*Multifamily:*

In order to limit the number of notes assigned to FHA, during the past few years HUD has been conducting auctions of notes that otherwise would have been assigned to it under the 221(g)(4) program. Under the 221(g)(4) program, performing loans can automatically be assigned to HUD if during the 20th year of the mortgage term the mortgage was current. Since October 1991, HUD has held three auctions whereby the beneficial interest in the mortgage is sold in lieu of accepting assignment. FHA then makes subsidy payments when the market interest rates obtained from the auction exceed the mortgage note interest rate. Through note auctions, to date HUD has avoided the assignment of approximately 230 mortgages with an unpaid principal balance of over $200 million. HUD intends to continue to hold multifamily 221(g)(4) mortgage auctions until the 221(g)(4) option expires for all mortgages currently insured pursuant to that section.

To reduce the number of assigned notes already in the Secretary-held portfolio, HUD is planning to sell a large portion of the multifamily note portfolio during the next few years and has obtained the services of a financial advisor to assist with the sale of the assigned notes. HUD intends to reduce the portfolio by:

- Selling performing Secretary-held 221(g)(4) notes in regularly scheduled auctions. These notes entered the assigned inventory prior to HUD initiating the auctions discussed above. HUD has received approval from OMB to sell performing mortgages without mortgage insurance.

- Selling performing mortgages, and also those non-performing mortgages which HUD believes will be able to be worked out by the mortgagee. HUD has received approval from OMB to sell unsubsidized mortgages without insurance, and a limited number of subsidized mortgages with insurance in a demonstration program.

*Single Family:*

The Office of Single Family Housing has determined that they will perform the following steps to resolve the single family assigned portfolio:

- *Develop goals for returning seriously delinquent notes to current status or have them foreclosed* -- HUD has established a goal for each field office to return delinquent mortgagors to performing status or foreclose on the mortgage.

- *Conduct a sale of performing 221(g)(4) mortgages* -- As with multifamily 221(g)(4) Secretary-held mortgages. HUD is also assessing the possibility of selling a number of (approximately 15 percent of the current portfolio) performing 221(g)(4) mortgages A sale is expected to occur in late fiscal year 1994.

- *Conduct a sale of other current Secretary-held mortgages and delinquent notes after conclusion of the assistance period* -- Based on the success of the sale of the performing 221(g)(4) mortgages summarized above, HUD intends to assess whether it is beneficial, and legal, to sell a number of the remaining performing and non-performing mortgages

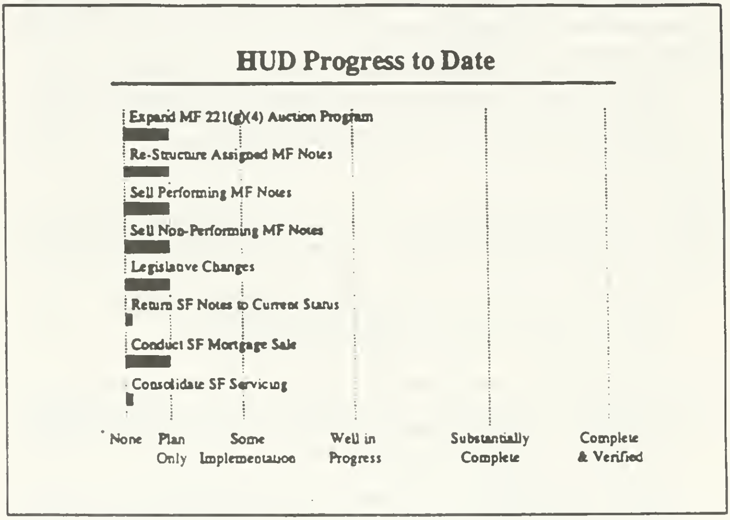
- *Consolidate the Single Family servicing function into fewer locations and contract out in whole, or portions of, the servicing function*

*Price Waterhouse Assessment of Planned and Completed Actions:*

We believe that HUD's action plan effectively addresses our recommendations and we encourage its rapid implementation. In particular, selling a considerable portion of the Secretary-held mortgage note portfolios would be a positive step in reducing the workload for field office staff. The reduction in the amount of Secretary-held mortgages will also allow the field office staff to concentrate their limited resources on monitoring the financial and operational health of the insured portfolio, and consequently reduce the amount of losses incurred by the FHA Fund.

The chart below (Chart 5) is a depiction, by major action area, of our assessment of HUD's progress toward implementation of a resolution plan for Secretary-Held Multifamily and Single Family mortgages:

Chart 5



## CONTINUED EMPHASIS MUST BE PLACED ON IMPROVING ACCOUNTING AND FINANCIAL MANAGEMENT SYSTEMS

In our previous reports on internal controls, we disclosed weaknesses involving FHA's financial management systems. While FHA has taken steps toward solving some of these weaknesses, we believe that additional effort is still necessary to: (1) enhance the general ledger and subsidiary systems to allow for the production of financial reports for each major FHA program, by geographical region, and to facilitate Credit Reform budget and credit reporting; (2) develop a multifamily system which will allow for the effective monitoring of the insured portfolio and act as an early warning system; and (3) over the long term, implement the systems improvement and integration strategy developed by HUD management as it applies to FHA operations.

We noted that HUD has developed a number of high level management reports to monitor the activities of the programs in the FHA Fund which provide information and financial indicators about regional and program activity; however, financial information categorized by FHA's programs is still limited. Since program-specific general ledger-based financial reports cannot currently be produced, FHA's losses can only be attributed to major activities, such as the Mutual Mortgage Insurance (MMI) or General Insurance (GI) Funds, and in some cases to single family versus multifamily, but cannot be pinpointed with precision to individual programs, many of which possess unique purposes and unique financial characteristics. Management believes that periodic actuarial reviews performed by actuarial and statistical staff are adequate to keep management abreast of the activities in each of the major programs. We continue to believe that in order to allow managers to operate on a completely informed basis, and to facilitate full accountability throughout the agency, FHA must systematically produce accurate, accrual-based financial information for its major programs on a regional basis. This is particularly important as HUD takes steps to reorganize and consolidate FHA's field structure.

Another important reason to improve financial systems is to ensure that FHA continues to comply with the budgetary requirements of the Federal Credit Reform Act (Credit Reform) and the implementing guidance in OMB Circulars A-11 and A-34. Credit Reform, which became effective for fiscal year 1992, requires among other things, that FHA segregate and separately account for the activities and credit subsidies for each of the FHA Funds. To date FHA has not modified its systems to facilitate Credit Reform budgetary accounting and reporting, nor has FHA developed a plan for ultimately complying with these reporting requirements. While Credit Reform reporting is not a major issue at the present time, it will become more significant as FHA adds more and more credit cohorts in subsequent years. Given Credit Reform's detailed budgetary requirements, it will become essential for HUD to develop or modify automated systems to assure continued compliance. In addition, it will also become critical if the Federal Financial Accounting Standards Advisory Board (FASAB), which is developing accounting standards for Federal government entities, concludes that the activities of FHA will be required to comply with its accounting standards. FASAB is currently developing accounting standards which, for financial accounting, embrace the budgetary accounting concepts of Credit Reform. HUD management has indicated that due to the lack of funds, they are not able to completely modify existing systems to perform the reporting as currently required by OMB.

With respect to the development of a database of information for each of the insured multifamily projects, HUD began the process of collecting financial and operational data on multifamily loans insured under the FHA programs. Detailed information on approximately 12% of this portfolio was obtained for loss reserve calculation purposes. However, HUD continues to lack a central database for all insured multifamily loans and a system that provides reports on the financial and operational status of individual loans at the field office, regional office, and headquarters levels. As discussed above, the Multifamily National System (MNS) is being developed as an interim system to assist the HUD staff in monitoring insured mortgages and to allow senior management to properly oversee these efforts. During fiscal year 1994, HUD contracted with a firm to assist them in entering financial statement data for all insured projects into the database. Until improvements to the multifamily insurance system are completed, and the above weaknesses fully addressed, HUD does not have complete and reliable financial information concerning multifamily insured loans, and management does not have the proper tools to facilitate and monitor programmatic and regional accountability.

**HUD Action Plan to Address Systems Weaknesses:**

We understand that HUD has developed an overall integration strategy which encompasses FHA and which management believes can be implemented within the current budgetary restrictions. This strategy is based on systems integration on a program-line basis (Single Family, Multifamily, and Title I) and contains elements to replace many of the ineffective systems currently being operated, while saving much of the current computer coding from those systems which have performed well. This umbrella system is to be called FHAMIS Where feasible, FHAMIS will use state-of-the-art technology (such as electronic data interchange) to improve the operations of the systems.

Under this new umbrella system, the following is planned over the long term:

- Eliminate data redundancies in the single family insurance systems where possible and maintain common databases where possible.
- Create a new unified single family insurance premium billing and reconciliation module which will replace a number of old and disjointed premium systems.
- Create a new single family property system real estate-owned (REO) management system.
- Bring a previously contractor-run single family notes system in-house to run as a module of FHAMIS.
- Create a new assigned multifamily notes system.
- Create a new multifamily foreclosed property management system if the level of Secretary-held properties continues to be significant.

Short term improvements include:

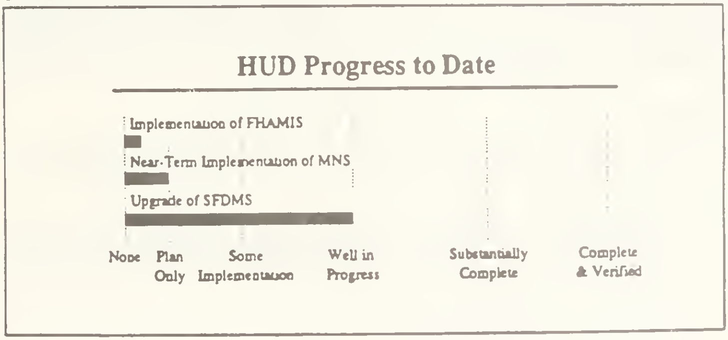
- Completion of database and near term enhancements for the Multifamily National System.
- Upgrade SFDMS.

*Price Waterhouse Assessment of HUD Action Plan:*

We continue to believe that financial statement information on a program by program and regional basis will greatly improve the ability of management to identify those programs which are performing outside expected norms. HUD should consider incorporating this feature in FHAMIS. The development of the FHAMIS system as it is currently envisioned will, in our view, improve the general operations and management of FHA. Management should ensure that the system is developed in such a manner as to allow reporting on a program by program basis and also to report activity in accordance with the Credit Reform Act.

The chart below (Chart 6) is a depiction, by major action areas, of our assessment of HUD's progress toward implementation of new or improved accounting and financial management systems:

Chart 6



*REPORTABLE CONDITION*

**FHA MUST PERFORM A COMPLETE REVIEW OF THE SECURITY AND PROCESSING CONTROLS FOR ALL COMPUTER SYSTEMS**

HUD must rely heavily on computerized information systems to process the large volume of data required for such a diverse insurance operation. These systems not only process accounting data for a number of functions, such as insurance processing, servicing, and asset disposition, but they also process a large amount of cash receipts and disbursements. In our prior internal control report, we recommended that HUD perform complete application controls reviews for all of the FHA systems and that these reviews include all aspects of systems access and security controls as well as input and processing controls. During our review of the significant FHA systems, we noted that the internal controls surrounding access to these systems, and key input and processing controls surrounding them were not adequate to provide reasonable assurance that (1) funds, property, and assets are safeguarded against waste, loss, and unauthorized use or misappropriation; and (2) assets, liabilities, revenues, and expenses applicable to operations are properly recorded and accounted for to permit the preparation of reliable financial reports and to maintain accountability over FHA's assets. These weaknesses indicate that there is a systemic breakdown in the management and review of internal controls in these systems.

For example, we noted that:

- Some systems do not have varied levels of access authority to limit the capabilities individuals possess within the systems.
- Periodic reviews of lists of individuals authorized to access the systems are not always performed, or are not always effective, to ensure that access privileges are terminated for individuals who no longer require access to the system to perform their duties.
- Segregation of duties is not always maintained.
- Key edit checks are not always in place to ensure that the integrity of the data is maintained.
- Controls over the manual entry/modification of information in the systems are not always maintained.
- Normal security features of a properly designed system do not always exist. For example, we noted that reports are not always available which provide detailed listings of invalid attempts to access the system, or attempts to access portions of the system for which employees are not approved for

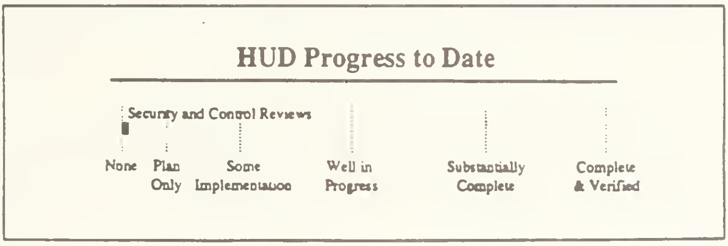
As discussed above, as part of its system integration strategy, during the next 5 years HUD is planning to replace a number of its critical financial and management systems where we have noted weaknesses. The systems being replaced include the single family premiums systems and property system, and the multifamily insurance, mortgage notes, and REO management systems.

***Price Waterhouse Assessment of Planned and Completed Actions:***

During the development of new systems it is critical that HUD staff build into the applications proper internal controls. These controls should include key input and processing, and security and access controls to provide reasonable assurance that the assets of FHA are safeguarded and properly recorded and accounted for. For those systems which are not being replaced, and those that will not be replaced within the next 2 years, we continue to recommend that complete application controls reviews be performed for these systems and that these reviews include all aspects of systems access and security controls as well as input and processing controls.

The chart below (Chart 7) is a depiction, by major action area, of our assessment of HUD's progress toward implementation of a complete review of the security and processing controls for all computer systems:

Chart 7



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These conditions were considered in determining the nature, timing, and extent of audit tests to be applied in our examination of the 1993 financial statements, and this report does not affect our report on these financial statements dated May 31, 1994.

In addition to the matters discussed above, we noted others involving the internal control structure and its operation that we are reporting to FHA's management in a separate letter.

This report is intended for the information of the Inspector General, management of the Department of Housing and Urban Development and Congress. However, this report is a matter of public record and its distribution is not limited.

Price Waterhouse

Washington, D.C.
May 31, 1994

Office of Government Services
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Washington, DC 20006

Telephone 202 296 0800

**Price Waterhouse**

**REPORT OF INDEPENDENT ACCOUNTANTS
ON COMPLIANCE WITH LAWS AND REGULATIONS**

To the Inspector General,
U.S. Department of Housing and Urban Development

We have audited the consolidated financial statements of the Federal Housing Administration (FHA), an agency operated by the Department of Housing and Urban Development (HUD), as of and for the year ended September 30, 1993, and have issued our report thereon dated May 31, 1994.

Except as explained in the third paragraph of our report on FHA's consolidated financial statements, we conducted our audit in accordance with generally accepted auditing standards, and *Government Auditing Standards*, issued by the Comptroller General of the United States, and the Office of Management and Budget (OMB) Bulletin 93-06, *Audit Requirements for Federal Financial Statements*. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

Compliance with laws and regulations applicable to FHA is the responsibility of FHA's management. As part of obtaining reasonable assurance about whether the financial statements are free of material misstatement, we performed tests of FHA's compliance with certain provisions of laws and regulations. However, the objective of our audit of the financial statements was not to provide an opinion on overall compliance with such provisions. Accordingly, we do not express such an opinion.

Material instances of noncompliance are failures to follow requirements, or violations of prohibitions, contained in law or regulations that cause us to conclude that the aggregation of the misstatements resulting from those failures or violations is material to the consolidated or consolidating financial statements or the sensitivity of the matter would cause it to be perceived as significant by others. The results of our tests of compliance disclosed the following instance of noncompliance.

**HUD Must Clarify and Substantiate How FHA's MMI Fund Will Comply with Credit Reform Act Reporting**

The Federal Credit Reform Act of 1990 (Public Law 101-508) (Credit Reform) and the implementing OMB guidance broadly require that the cash flows associated with FHA's pre-fiscal year 1992 credits be accounted for separately from the cash flows for the post fiscal year 1991 credits. Pre-fiscal year 1992 cash is to be accounted for in a "liquidating account," while post-fiscal year 1991 cash is to be accounted for in a "financing account." However, during fiscal year 1993, HUD did not transfer approximately $500 million in premium collections, related to refinancings, to the 1993 MMI Fund Financing Account from the MMI Fund Liquidating Account. We believe that a strict interpretation of Credit Reform would require such a transfer. This amount represents approximately 25% of the premiums due on the new mortgages.

During fiscal year 1993, nearly 40 percent of FHA's insurance endorsements were for refinancing of previously existing FHA-insured mortgages. When an FHA-insured mortgage is refinanced with another FHA-insured mortgage, the unearned portion of the premium, which would normally be refunded to the mortgagor, is instead credited against the premium due on the newly refinanced mortgage. Insured mortgagors pay any amount not covered by the credited premium. However, for those mortgages refinanced in 1993, the premiums recorded in the 1993 MMI Fund Financing Account included only the new premium payment, and excluded the refunded portion that was credited against the new premium. This resulted in the MMI Fund Liquidating Account being overstated by $500 million, and the MMI Fund Financing Account being understated by $500 million.

HUD management believes there are extenuating circumstances involving the applicability of Credit Reform to the MMI Fund that make this issue less significant. Foremost among them are the MMI Fund's statutorily-mandated capital ratio requirement, and its standing as a mutual insurance fund. Thus, resources generated by MMI are either held to meet capital requirements or distributed to borrowers once capital requirements are met. In these circumstances, HUD contends that the budgetary account breakdown has little meaning or impact on the MMI Fund.

We agree with HUD management that Credit Reform's impact on MMI is unclear, and we are inclined to view this as largely a technical issue. Moreover, it has no impact on our report on FHA's financial statements. Nevertheless, it is imperative that this issue be resolved as quickly as possible. If it is determined that the MMI Fund must comply with Credit Reform, FHA should ensure its systems are enhanced so that the cash flows for each category of loans are tracked in accordance with the requirements of Credit Reform.

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We considered this instance of noncompliance in forming our opinion on whether FHA's 1993 financial statements are presented fairly, in all material respects, in conformity with generally accepted accounting principles, and this report does not affect our report dated May 31, 1994 on those financial statements.

Except as described above, the results of our tests indicate that, with respect to the items tested, FHA complied, in all material respects, with the provisions referred to in the third paragraph of this report. With respect to items not tested, nothing came to our attention that caused us to believe that FHA had not complied, in all material respects, with those provisions referred to in the third paragraph of this report.

This report is intended for the information of the Office of Inspector General, the management of the Department of Housing and Urban Development, and Congress. However, this report is a matter of public record and its distribution is not limited.

Price Waterhouse

Washington, D.C.
May 31, 1994

## FEDERAL HOUSING ADMINISTRATION
## (AN AGENCY OF THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT)
## CONSOLIDATED STATEMENT OF FINANCIAL POSITION
## SEPTEMBER 30, 1993 AND 1992

(Dollars in Millions)

| | September 30, 1993 | September 30, 1992 |
|---|---|---|
| ASSETS: | | |
| Fund Balances at the U.S. Treasury: | | |
| Non-interest-bearing | $ 834 | $ 269 |
| Interest-bearing | 921 | 741 |
| Total Fund Balances at the U.S. Treasury | 1,755 | 1,010 |
| Investments in U.S. Government Securities (Note 3) | 5,155 | 5,789 |
| Foreclosed Property Held for Sale, Net (Note 4) | 1,592 | 1,515 |
| Mortgage Notes Receivable, Net (Note 5) | 5,861 | 5,354 |
| Other Assets and Receivables | 500 | 461 |
| Total Assets | $ 14,863 | $ 14,129 |
| LIABILITIES AND GOVERNMENT EQUITY: | | |
| Claims Payable | $ 678 | $ 762 |
| Loss Reserves (Note 6) | 12,879 | 14,663 |
| Unearned Premiums (Note 7) | 6,482 | 6,235 |
| Debentures Issued to Claimants (Note 8) | 213 | 301 |
| Accounts Payable, Accrued Expenses and Other Liabilities | 597 | 558 |
| Distributive Shares and Premium Refunds Payable | 305 | 302 |
| Total Liabilities | $ 21,154 | $ 22,821 |
| Government Equity (Deficiency) (Note 9): | | |
| Mutual Funds Equity | 1,171 | 1,165 |
| Subsidized Funds Cumulative Losses | (22,642) | (24,260) |
| Appropriated Capital | 15,180 | 14,403 |
| Total Government (Deficiency) | $ (6,291) | $ (8,692) |
| Commitments and Contingencies (Notes 11 and 12) | | |
| Total Liabilities and Government Deficiency | $ 14,863 | $ 14,129 |

The notes to the financial statements are an integral part of this statement.

## FEDERAL HOUSING ADMINISTRATION
## (AN AGENCY OF THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT)
## CONSOLIDATED STATEMENT OF OPERATIONS
## FOR THE YEARS ENDED SEPTEMBER 30, 1993 AND 1992
(Dollars in Millions)

| | 1993 | 1992 |
|---|---|---|
| REVENUES: | | |
| Premiums: | | |
| Annual Premiums | $ 572 | $ 411 |
| Earned Portion of Up-front Premiums | 1,075 | 1,173 |
| Total Premiums Earned | 1,647 | 1,584 |
| Interest Income | 811 | 827 |
| Other Revenues | 200 | 178 |
| Total Revenues | $ 2,658 | $ 2,589 |
| EXPENSES: | | |
| (Decrease) Increase in Loss Reserves | (1,784) | 6,558 |
| Provision for Losses on Properties Owned | 1,981 | 1,299 |
| Provision for Losses on Mortgage Notes Held | 164 | 914 |
| Salary and Administrative Expenses | 514 | 501 |
| Other Expense | 157 | 142 |
| Total Expenses | $ 1,032 | $ 9,414 |
| Excess (Deficiency) of Revenues over Expenses | $ 1,626 | $ (6,825) |

The notes to the financial statements are an integral part of this statement.

# FEDERAL HOUSING ADMINISTRATION
## (AN AGENCY OF THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT)
## CONSOLIDATED STATEMENT OF GOVERNMENT EQUITY (DEFICIENCY)
## FOR THE YEARS ENDED SEPTEMBER 30, 1993 AND 1992
(Dollars in Millions)

| | Cumulative Results of Operations | | Appropriated Capital | | |
|---|---|---|---|---|---|
| | Mutual Funds Equity | Subsidized Funds Cumulative Losses | Pre-Fiscal 1992 | Fiscal 1992/93 | Total |
| Balance at September 30, 1991 | $ 872 | $ (17,140) | $ 12,921 | $ 0 | $ (3,347) |
| (Deficiency) Excess of Revenue over Expenses | 295 | (7,120) | 0 | 0 | (6,825) |
| Distributive Shares Declared | (2) | 0 | 0 | 0 | (2) |
| Credit Appropriations Received and Obligated to Finance | | | | | |
| Credit Subsidies on insured 1992 mortgages | 0 | 0 | 0 | 86 | 86 |
| Administrative Expenses | 0 | 0 | 0 | 189 | 189 |
| Losses on Loans insured Prior to Sept 30, 1991 | 0 | 0 | 1,207 | 0 | 1,207 |
| Balance at September 30, 1992 | 1,165 | (24,260) | 14,128 | 275 | (8,692) |
| Excess of Revenue over Expenses | 8 | 1,618 | 0 | 0 | 1,626 |
| Distributive Shares Declared | (2) | 0 | 0 | 0 | (2) |
| Credit Appropriations Received and Obligated to Finance | | | | | |
| Credit Subsidies on insured 1993 mortgages | 0 | 0 | 0 | 124 | 124 |
| Administrative Expenses | 0 | 0 | 0 | 187 | 187 |
| Losses on Loans insured Prior to Sept 30, 1991 | 0 | 0 | 500 | 0 | 500 |
| 1992 Credit Subsidy returned to Treasury as a result of re-estimate | 0 | 0 | 0 | (34) | (34) |
| Balance at September 30, 1993 | $ 1,171 | $ (22,642) | $ 14,628 | $ 552 | $ (6,291) |

The notes to the financial statements are an integral part of this statement.

# FEDERAL HOUSING ADMINISTRATION
## (AN AGENCY OF THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT)
## CONSOLIDATED STATEMENT OF CASH FLOWS
## FOR THE YEARS ENDED SEPTEMBER 30, 1993 AND 1992
(Dollars in Millions)

| | 1993 | 1992 |
|---|---|---|
| Cash Flows from Operating Activities: | | |
| Excess (Deficiency) of Revenues over Expenses (Losses) | $ 1,626 | $ (6,825) |
| Adjustments to Reconcile Losses to Net Cash Used by Operating Activities: | | |
| (Decrease) Increase in Loss Reserves | (1,784) | 6,558 |
| Up-front Premiums Collected | 2,541 | 1,785 |
| Up-front Premiums Refunded | (1,219) | (433) |
| Up-front Premiums Earned | (1,075) | (1,173) |
| Claims Settlement Payments | (6,210) | (6,818) |
| Collections of Principal on Notes Acquired in Claims Settlement | 915 | 447 |
| Proceeds from Disposition of Assets Acquired in Claims Settlement | 3,164 | 2,946 |
| Increase in Loss Allowances on Properties and Mortgages | 2,145 | 2,213 |
| (Increase) in Other Assets | (39) | (52) |
| (Decrease) in Claims Payable and Other Liabilities | (42) | (89) |
| Other, net | (604) | (36) |
| Net Cash (Used) by Operations | (582) | (1,477) |
| Cash Flows from Investing Activities: | | |
| Increase in Deposit in U.S. Treasury Interest-bearing Account | (180) | (741) |
| Purchase of Investment Securities | (2,313) | (396) |
| Proceeds from Redemptions of Investment Securities | 2,953 | 1,191 |
| Other, Net | 0 | 7 |
| Net Cash Provided by Investing Activities | 460 | 61 |
| Cash Flows from Financing Activities: | | |
| Appropriations Received | 777 | 1,482 |
| Issuance of Debentures to Claimants | 275 | 324 |
| Payment of Debentures | (363) | (359) |
| Distributive Shares Paid | (2) | (2) |
| Net Cash Provided by Financing Activities | 687 | 1,445 |
| Net Increase (Decrease) in Cash | 565 | 29 |
| Cash - Non-Interest-Bearing, Beginning of Year | 269 | 240 |
| Cash - Non-Interest-Bearing, End of Year | $ 834 | $ 269 |

The notes to the financial statements are an integral part of this statement.

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

## SEPTEMBER 30, 1993 AND 1992

### Note 1. Description of Entity and Significant Accounting Policies

#### Entity and Mission

The Federal Housing Administration (FHA) was established in 1934 and became a wholly owned government corporation in 1948 subject to the Government Corporation Control Act, as amended. FHA administers some 40 active mortgage insurance programs, thereby making mortgage financing more readily accessible to the home-buying public. Its programs are designed primarily to serve first-time home buyers and to provide affordable multifamily housing.

The FHA programs are organized into four major activities: (1) the Mutual Mortgage Insurance Fund (MMI), FHA's largest activity, provides basic (principally 30 year) single family mortgage insurance and is a mutual insurance fund whereby mortgagors, upon non-claim termination of their mortgages, share surplus premiums paid into the Fund that are not required for operating expenses and losses or to build equity; (2) the Cooperative Management Housing Insurance Fund (CMHI), also a mutual fund, provides mortgage insurance for management-type cooperatives; (3) the General Insurance Fund (GI), provides for a large number of specialized mortgage insurance programs, including insurance of loans for property improvements, cooperatives, condominiums, housing for the elderly, land development, group practice medical facilities and nonprofit hospitals; and (4) the Special Risk Insurance Fund (SRI), provides mortgage insurance on behalf of mortgagors eligible for interest reduction payments who otherwise would not be eligible for mortgage insurance. The MMI and CMHI Funds were designed to be operated in accord with "sound actuarial and accounting practice", and thus borrowers are to be charged a premium that will cover default losses and administrative expenses, and provide equity. These Funds are not to be dependent upon appropriations to sustain operations. The GI and SRI Funds, however, were not designed to be self-sustaining, and as a result, are dependent on appropriations from Congress to sustain their operations.

While FHA was established as a separate federal entity, it was subsequently merged into the Department of Housing and Urban Development (HUD) when that department was created. FHA no longer has separate staff or facilities. Instead, FHA operations are conducted, along with other Housing activities, by HUD organizations. FHA is headed by HUD's Assistant Secretary for Housing - Federal Housing Commissioner, who reports to the Secretary of HUD. FHA's activities are included in the Housing section of the HUD budget.

#### Basis of Accounting

The Consolidated Statement of Financial Position, Statement of Operations, Statement of Government Equity (Deficiency), and Statement of Cash Flows, have been prepared in accordance with generally accepted accounting principles. All material interfund balances and transactions have been eliminated.

#### Fund Balances at the U.S. Treasury

Substantially all of FHA's receipts and disbursements are processed by the U.S. Treasury through either an interest or non-interest-bearing account. All cash generated from insurance endorsed on or after October 1, 1991 is deposited in an interest-bearing account in accordance with the Federal Credit Reform Act of 1990 (Credit Reform) -- see Note 10. The account earns interest at a rate based on a maturity interval of 10 years and longer, as determined by the U.S. Treasury. The non-interest-bearing account comprises uninvested cash emanating from insurance endorsed prior to October 1, 1991 (pre-fiscal year 1992 credits). Prior to Credit Reform, cash generated from insurance endorsements not needed for short term operating purposes was invested in non-marketable U.S. Government Securities with terms similar to securities which are publicly marketed.

For purposes of the Statement of Cash Flows, non-interest-bearing funds at Treasury are considered cash equivalents. Interest-bearing funds at the U.S. Treasury are considered an investing activity, since Credit Reform did not, in substance, change the liquidity of the funds.

**Investments in U.S. Government Securities**

Prior to the enactment of Credit Reform, the National Housing Act, as amended, limited FHA's investments to non-marketable Treasury interest-bearing obligations (i.e., investments not sold in public markets). The market value and interest rates established for such investments were the same as those for similar publicly marketed Treasury issues.

Investments in U.S. Government securities are reported at the lower of cost, net of unamortized premiums or discounts, or market (see Note 3). Management's intent is to hold investments to maturity unless they are needed to finance mortgage insurance claims or otherwise sustain the operations of the Fund.

In May 1993, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 115, Accounting for Certain Investments in Debt and Equity Securities. This Statement requires FHA to categorize its investment portfolio according to its ability and intent to hold the investments to maturity. Investments which FHA does not have the ability or intent to hold to maturity are considered to be available for sale and must be recorded at market, and the unrealized gains/losses recognized as an increase/decrease to Government Equity. FHA has not yet determined what impact this statement will have to the financial statements.

**Mortgage Notes Receivable**

Mortgage notes receivable consist of mortgage notes received in claims settlement. Under certain conditions prescribed by regulation, FHA will take assignment of insured mortgages which are in default rather than acquire the properties through foreclosure. Single family mortgages can be assigned to FHA when the mortgagor has defaulted due to certain "temporary hardship" conditions beyond the control of the mortgagor, in management's judgment, it is likely that the mortgage can be brought current in the future. However, the majority of FHA single family claims do not result in the assignment of notes. Lenders holding defaulted multifamily mortgages may make mortgage insurance claims by assigning the mortgages to FHA. In addition, performing notes insured pursuant to Section 221(g)(4) of the National Housing Act may be assigned to FHA at a pre-determined point in time (see Note 12).

For financial statement purposes, mortgage notes received in claim settlement are recorded at the lower of cost or fair value. Fair value is based on prevailing market interest rates at the date of mortgage assignment. When fair value is less than cost, discounts are recorded and amortized to interest income over the remaining terms of the mortgages. Interest is recognized as income when earned. When full collection of principal is considered doubtful, an allowance for losses is recorded, the accrual of interest income is suspended, and receipts (both interest and principal) are recorded as collections of principal. Mortgage notes receivable are reported net of the allowance for loss and any unamortized discount.

**Foreclosed Property Held for Sale**

Foreclosed property held for sale is reported net of an allowance for loss, which is established to reduce the property carrying value to the estimated net realizable value -- the amount FHA expects to receive in cash upon sale of the property.

**Loss Reserves**

Loss reserves in the MMI Fund comprise claims loss reserves and loss adjustment expense reserves, and are provided for estimated losses incurred by FHA to pay claims on insured mortgages when defaults have taken place, but where claims have not yet been filed. Claims loss reserves in the GI and SRI Funds are recorded when defaults are considered probable but have not yet been reported as such to FHA.

**Premiums and Unearned Revenue**

Prior to July 1991, FHA's largest activity, the insurance of single family mortgages by the MMI Fund, charged a one-time premium upon initiation of insurance. On July 1, 1991, the premiums charged by FHA for this insurance were restructured to include both an up-front and a risk-based annual premium. The one-time and up-front premiums are recorded as unearned revenue upon collection and are recognized as revenue over the period in which losses are expected to occur. The risk-based annual premiums are earned on a straight-line basis throughout the year. FHA's other activities, including most of those conducted through the GI and SRI Funds, charge periodic premiums over the mortgage insurance term. Premiums on annual installment policies are earned on a straight-line basis throughout the year.

### Appropriations and Funds Received from Other HUD Programs

The GI and SRI Funds were not designed to be self-sustaining. As a result, the National Housing Act, as amended, provides for appropriations from Congress to cover the losses in these Funds.

The Credit Reform Act of 1990 changed the method by which FHA receives appropriations from Congress. Beginning in fiscal year 1992, appropriations to the GI and SRI Funds are made at the beginning of each fiscal year to cover estimated losses on loans to be insured during that year. The revised appropriation structure also authorizes permanent indefinite appropriation authority to finance the cash requirements of operations resulting from endorsements in years prior to fiscal year 1992.

Funds received from other HUD programs, such as for interest subsidies and rent supplements, are recorded as revenue when services are rendered

### Distributive Shares

As mutual funds, the MMI and CMHI Funds distribute excess revenues to mortgagors at the discretion of the Secretary of HUD. Such distributions are determined based on the MMI and CMHI Funds' financial positions and their projected revenues and costs. In November 1990, Congress passed the National Affordable Housing Act which effectively suspended payment of distributive shares from the MMI Fund, other than those already declared by the Secretary, until the Fund meets certain equity requirements (See Note 9). The declaration of distributive shares was suspended in November 1990. The National Affordable Housing Act does not affect the distributions from the CMHI Fund.

## Note 2. Intragovernmental Financial Activities

FHA is not a separate federal entity. It is an integral part of the operations of HUD, and is thus subject to financial decisions and management controls of the Secretary of HUD. Similarly, FHA is also subject to financial decisions and management controls of the Office of Management and Budget (OMB). Because FHA is not a separate or unrelated entity, its operations might not be conducted, nor its financial position reported as they would if FHA were autonomous.

### Rent Supplements and Interest Subsidies

HUD provides rent supplements and interest subsidies to lenders on behalf of certain eligible mortgagors and/or occupants of single and multifamily properties which FHA insures, or for which it holds the mortgage.

In those cases where FHA holds the mortgage, it receives any benefit payments from HUD on behalf of those individuals who are repaying the loan or occupying the property.

During fiscal years 1993 and 1992, FHA received directly the following interest subsidy and rent supplement payments from HUD (dollars in millions):

| Description | 1993 | 1992 |
|---|---|---|
| Multifamily Notes-Interest Subsidy | $ 42 | $ 43 |
| Rental Supplements for Low and Very Low Income Families | 20 | 18 |
| Total | $ 62 | $ 61 |

Amounts receivable from HUD as of September 30, 1993, and 1992 for the above assistance programs are not material.

To the extent FHA-insured mortgagors receive rent supplement payments and/or interest subsidy, FHA benefits indirectly since these assistance payments will reduce the risk of the mortgagors failing to repay the FHA-insured loans. With respect to rent subsidy payments, it is estimated that approximately 50% of the projects with FHA-insured loans (accounting for 40% of the insured unpaid principal balance) during fiscal year 1993 received rent supplement payments from HUD; and, that these payments accounted for approximately 60% of the aggregate rent revenue received by these projects. With respect to interest subsidy payments, lenders for approximately 20% of the insured mortgages (accounting for 10% of the insured unpaid principal balance) receive such subsidies under the Section 236 program. During fiscal year 1993, interest subsidy payments amounted to approximately 60% of the aggregate mortgage payments on these insured mortgages.

### Administrative Expenses Reimbursed to HUD

HUD is reimbursed by FHA for personnel, property and equipment, and administrative services costs since virtually all FHA operations are performed by HUD personnel. These annual reimbursements are budgeted amounts approved by Congress each fiscal year. They are based on the estimated staff levels used to carry out FHA activities, not the time actually worked by HUD personnel on those activities.

Allocated personnel costs for which FHA reimburses HUD include matching contributions to the Civil Service Retirement System (CSRS) and the Federal Employees Retirement System (FERS). FERS went into effect for all HUD employees on January 1, 1987, pursuant to Public Law 99-335. Although FHA effectively funds a portion of pension benefits under CSRS or FERS relating to its employees and makes the necessary payroll withholdings from them, it has no liability for future payments to employees under these programs nor does it report its portion of the actuarial present value of accumulated benefits or of the unfunded pension liability, since these amounts are reported in total by the Office of Personnel Management.

## Note 3. Investments in U.S. Government Securities and Interest-bearing Funds

FHA's normal policy is to hold investments in U.S. Government Securities to maturity. However, as a result of Credit Reform, cash collected on insurance endorsed on or after October 1, 1991 is no longer available to invest in U.S. Government securities, and may only be used to finance claims emanating from insurance endorsed subsequent to that date. Therefore, FHA may have to liquidate its U.S. Government securities before maturity to finance claim payments from pre-fiscal year 1992 insurance endorsements. Accordingly, FHA investment in U.S. Government securities is reported at the lower of amortized cost or market.

The amortized cost and the market value of investments in U.S. Government securities were as follows at September 30, 1993 and 1992 (dollars in millions):

| September 30, | 1993 | 1992 |
|---|---|---|
| Amortized Cost | $ 5,155 | $ 5,789 |
| Unrealized Gains | 665 | 656 |
| Unrealized Losses | 0 | 0 |
| Market Value | $ 5,820 | $ 6,445 |

Investments in U.S. Government securities are backed by the full faith and credit of the U.S. Government. Investment income on the investments in U.S. Government securities was $463 million for the year ended September 30, 1993, and $536 million for the year ended September 30, 1992, and is included in interest income on the Statement of Operations. Expenses relating to these investments are not significant.

The amortized cost and the market value of investments at September 30, 1993 by maturity period, were as follows (dollars in millions):

| Maturity | Amortized Cost | Market Value |
|---|---|---|
| Due One Year or Less | $ 411 | $ 415 |
| Due After One Year Through Five | 1,973 | 2,147 |
| Due After Five Years Through Ten | 1,478 | 1,642 |
| Due After Ten Years Through Fifteen | 972 | 1,179 |
| Due After Fifteen Years | 321 | 437 |
| Total Investments | $5,155 | $5,820 |

As of September 30, 1992, investments in U.S. Government securities were as follows (dollars in millions):

| Maturity | Amortized Cost | Market Value |
|---|---|---|
| Due One Year or Less | $ 451 | $ 478 |
| Due After One Year Through Five | 2,087 | 2,282 |
| Due After Five Years Through Ten | 1,958 | 2,183 |
| Due After Ten Years Through Fifteen | 620 | 699 |
| Due After Fifteen Years | 673 | 803 |
| Total Investments | $5,789 | $6,445 |

Proceeds from the redemptions and sales of investments in U.S. Government securities for the year ended September 30, 1993, were $2,953 million at a gross gain of $51 million. No losses were realized. For the year ended September 30, 1992, proceeds from sales and redemptions were $1,191 million at a gross gain of $25 million.

FHA's interest-bearing account at the U.S. Treasury earns interest at rates established by Treasury for Credit Reform accounts. The rates are based on the maturity of the loans FHA insures. Accordingly, FHA earns interest based on a maturity interval of 10 years and longer.

However, there are no penalties if FHA must use the cash in this account over a shorter period to finance credit losses from post-fiscal year 1991 insurance endorsements. This account earned interest at a weighted average rate of 6.58% for fiscal year 1993 and 7.5% for fiscal year 1992.

Interest income on credit reform related funds was $70 million for the year ended September 30, 1993, and $21 million for the year ended September 30, 1992, and is included in interest income on the Statement of Operations.

### Note 4. Foreclosed Property Held for Sale

Foreclosed property held for sale was composed of the following classes of property at September 30, 1993 and 1992 (dollars in millions):

| Description | 1993 | 1992 |
|---|---|---|
| Single Family Homes | $ 2,310 | $ 2,220 |
| Multifamily Properties | 823 | 647 |
| Total Property | 3,133 | 2,867 |
| Allowance for Losses | (1,541) | (1,352) |
| Property, Net | $ 1,592 | $ 1,515 |

Foreclosed property held for sale is obtained in claims settlement. The allowance for losses is recorded to reduce the property carrying value to the amount FHA expects to receive in cash when properties are sold. The allowance is necessary because historically, FHA has not recovered the full value of its foreclosed property and related costs.

Changes in the allowance for losses on property for the years ended September 30, 1993, were (dollars in millions):

| Description | 1993 | 1992 |
|---|---|---|
| Balance, Beginning of Year | $ 1,352 | $ 1,720 |
| Provision for Losses Charged to Operations | 1,981 | 1,299 |
| Realized Losses on Property Disposal | (1,792) | (1,667) |
| Balance, End of Year | $ 1,541 | $ 1,352 |

Realized losses on the disposal of foreclosed property, for each fund, for the years ended September 30, 1993 and 1992 were (dollars in millions):

| Fund | 1993 | 1992 |
|---|---|---|
| MMI | $ 1,435 | $ 1,427 |
| CMHI | 0 | 0 |
| GI | 322 | 217 |
| SRI | 35 | 23 |
| Total | $ 1,792 | $ 1,667 |

## Note 5. Mortgage Notes Receivable

Mortgage notes receivable comprised the following at September 30, 1993 and 1992 (dollars in millions):

| Description | 1993 | 1992 |
|---|---|---|
| Performing | | |
| Single Family | $ 1,396 | $ 1,337 |
| Multifamily | 1,841 | 1,943 |
| Title I | 21 | 21 |
| Total Performing | 3,258 | 3,301 |
| Unearned Discount | (457) | (494) |
| Performing Mortgages, Net | 2,801 | 2,807 |
| Non-Performing | | |
| Single Family | 2,437 | 2,005 |
| Multifamily | 6,008 | 5,836 |
| Title I | 362 | 386 |
| Total Non-performing | 8,807 | 8,227 |
| Allowance for Losses | (5,747) | (5,680) |
| Non-performing Mortgages, Net | 3,060 | 2,547 |
| Total Mortgages | 12,065 | 11,528 |
| Total Unearned Discount and Allowance for Losses | (6,204) | (6,174) |
| Mortgages, Net | $ 5,861 | $ 5,354 |

Most of the mortgage notes held were assigned to FHA when mortgagors defaulted (i.e. mortgage notes assigned, MNAs). In addition, performing notes insured pursuant to Section 221(g)(4) of the National Housing Act may be assigned automatically to FHA at a pre-determined point in time (see Note 12). FHA takes assignment of single family notes when defaults result from temporary hardship conditions. Defaulted multifamily notes may be assigned to FHA without such restrictions.

Many of the mortgages held are in default and are no longer generating interest income. An allowance for losses is recorded on these notes. Where the ultimate collectibility of a note is in doubt, any payments received on that note are applied to reduce principal, to the extent necessary to reduce the note to its net realizable value. Any such amounts applied against the notes are shown as an additional allowance.

Where mortgages are acquired at interest rates below the market interest rate in the year acquired, the mortgages are discounted. This discount reduces the fair value of the mortgages such that the effective interest rate approximates the market interest rate in the year of acquisition. The weighted average nominal interest rates for all mortgages are 9.94% on single family notes; 8.16% on multifamily notes; and 8.04% on Title I notes. The effective interest rates after discounting are 11.25% on single family notes; 10.02% on multifamily notes; and 8.04% on Title I notes. Mortgages which are considered current but which are under forbearance agreements comprise approximately $1,162 million of the entire single family portfolio.

Interest income was $275 million for the year ended September 30, 1993, and $269 million for the year ended September 30, 1992. If interest on the non-performing mortgages had been accrued, that interest income would have approximated $744 million for the year ended September 30, 1993, and $603 million for the year ended September 30, 1992.

Changes in the allowance for losses and unearned discounts on mortgage notes receivable for the years ended September 30, 1993 and 1992, were (dollars in millions):

| Description | 1993 | 1992 |
|---|---|---|
| Balance, Beginning of Year | $ 6,174 | $ 5,215 |
| Change in Allowance: | | |
| Charged to Operations | 164 | 914 |
| Amortization of Discount | (51) | (29) |
| Notes Written Off and Foreclosed | (414) | (157) |
| Delinquent Principal Recoveries | 331 | 231 |
| Balance, End of Year | $ 6,204 | $ 6,174 |

Given the non-performing status of a vast majority of the mortgage notes portfolio, and the lack of marketability of these notes, it is not meaningful to calculate the fair value of these receivables.

Note 6. Loss Reserves

Loss reserves for claims and loss adjustment expenses (LAE), were as follows as of September 30, 1993 and 1992 (dollars in millions):

| Fund | Claims Loss Reserve | LAE Reserve | 1993 Total | 1992 Total |
|---|---|---|---|---|
| MMI | $ 2,039 | $ 132 | $ 2,171 | $ 2,215 |
| CMHI | 6 | 0 | 6 | 0 |
| GI | 8,475 | 222 | 8,697 | 10,581 |
| SRI | 1,946 | 59 | 2,005 | 1,867 |
| Total | $ 12,466 | $ 413 | $ 12,879 | $ 14,663 |

The MMI Fund records a claims loss reserve to provide for estimated losses incurred by FHA to pay claims on insured mortgages where defaults have taken place, but where claims have not yet been filed. The reserve is estimated based on historical claim and loss experience data, adjusted for judgments concerning current economic factors.

Discounted claims loss reserves in the GI and SRI Funds are recorded when loan defaults are considered probable but have not yet been reported as such to FHA. Prior to September 30, 1992, management was not able to determine whether the loss reserves recorded for the GI and SRI Fund's were sufficient to cover probable losses in the multifamily programs. This was caused by the lack of complete and accurate financial information on individual loans and by the lack of an internal loan/risk classification process. For the second consecutive year, management conducted a special project to review the credit risk of its insured multifamily portfolio, and calculated a loss reserve as of September 30, 1993. Management collected financial and operational information for approximately 12% of the insured projects and analyzed the resulting information to determine the potential of the mortgage portfolio to default and result in a claim payment. Based on this review, loss reserves were decreased by approximately $1,600 million through a credit to fiscal year 1993 operations. The multifamily loss reserves recorded for the GI and SRI Funds, including loss adjustment expense, as of September 30, 1993, amount to $8,350 million and $1,950 million, respectively.

This decrease in the loss reserves for the GI and SRI Funds is primarily attributable to: (1) decreases in the expected claims for projects ranked in the least risky categories in light of improvements in the economy; (2) payment of claims; (3) increases in the amounts expected to be recovered in the ultimate resolution of default claims from the Coinsurance program; and (4) a general improvement in the risk ranking of insured projects as a result of the 1993 portfolio assessment.

Loss reserves have been established for 35% of the multifamily projects insured by the GI and SRI Funds. Management believes that this level of reserves is necessary because multifamily insurance claim payments are expected to increase significantly in subsequent years. This increase is based upon managements consideration of: (1) the current financial and operational status of the multifamily projects in the portfolio; (2) the anticipated future cash requirements relating to major repairs and maintenance needed by these projects; and (3) the anticipated availability of cash inflows in the form of rent or rent assistance for these projects.

The multifamily loss reserves recorded as of September 30, 1992 were significantly greater than the loss reserves recorded in previous years because 1992 was the first time FHA assessed default risk on existing insured multifamily loans. Consequently, the entire increase to multifamily loss reserves was recorded in fiscal year 1992, and not in the year in which the underlying project financial, operational or economic events that gave rise to the increase took place.

Aggregate premiums generated by the GI and SRI Funds' various programs will not be sufficient to cover losses in the Funds, nor to sustain their operations. The severity of the losses in these funds and the insufficiency of their premiums leave the Funds dependent on budget appropriations to sustain their operations as originally intended under statutes. While activity in the GI Fund programs continues to be significant, activity in all of the SRI Fund's major programs has decreased substantially in recent years.

The LAE reserve is provided for estimated administrative expenses of settling claims on those defaults in the claims loss reserve.

## Financial Statements

### Note 7. Unearned Premiums

The following shows the activity in unearned premiums during 1993 (dollars in millions):

| | MMI | CMHI | GI | SRI | Total |
|---|---|---|---|---|---|
| Beginning Balance | $ 6,125 | $ 1 | $ 92 | $ 17 | $ 6,235 |
| Premiums Collected | 2,258 | 2 | 244 | 37 | 2,541 |
| Premiums Earned | (820) | (2) | (216) | (37) | (1,075) |
| Premium Refunds | (1,211) | 0 | (8) | 0 | (1,219) |
| Ending Balance | $ 6,352 | $ 1 | $ 112 | $ 17 | $ 6,482 |

The following shows the activity in unearned premiums during 1992 (dollars in millions):

| | MMI | CMHI | GI | SRI | Total |
|---|---|---|---|---|---|
| Beginning Balance | $ 5,934 | $ 1 | $ 105 | $ 16 | $ 6,056 |
| Premiums Collected | 1,524 | 2 | 222 | 37 | 1,785 |
| Premiums Earned | (911) | (2) | (224) | (36) | (1,173) |
| Premium Refunds | (422) | 0 | (11) | 0 | (433) |
| Ending Balance | $ 6,125 | $ 1 | $ 92 | $ 17 | $ 6,235 |

### Note 8. Debentures Issued to Claimants

The National Housing Act authorizes FHA, in certain cases, to issue debentures in lieu of cash to pay claims. FHA-issued debentures bear interest at rates established by Treasury. Interest rates of the outstanding debentures range from 3.125% to 12.875%. They may be redeemed by lenders prior to maturity to pay mortgage insurance premiums to FHA.

Debentures outstanding at September 30, 1993, and September 30, 1992, were as follows (dollars in millions):

| Due: | 1993 | 1992 |
|---|---|---|
| One Year or Less | $ 2 | $ 2 |
| After One Year Through Five | 20 | 28 |
| After Five Years Through Ten | 30 | 68 |
| After Ten Years Though Fifteen | 2 | 50 |
| After Fifteen Years | 159 | 153 |
| Total | $ 213 | $ 301 |

Interest expensed for debentures during the year ended September 30, 1993, was $50 million, and during the year ended September 30, 1992, was $69 million. Interest is payable on January 1 and July 1 of each year.

On January 1, 1994, the Federal Housing Commissioner called all debentures outstanding as of September 30, 1993 with coupon rates of 6.5% or higher. The amount of debentures called totalled $175 million. The remaining debentures bear interest at rates ranging from 3.125% to 6.375%.

Based on the long-term interest rate available to FHA, the fair value of the debentures outstanding at September 30, 1993 was $295 million based on the original maturity date for each debenture, and $220 million based on the original maturity date, or the January 1, 1994 call date, for each debenture, as applicable.

### Note 9. Government Equity

The equity of the MMI Fund is maintained in the general surplus account, and the equity of the CMHI Fund is maintained in the general surplus account and the participating reserve account. The general surplus account is available for operating purposes, and the participating reserve account is used to pay distributive shares to policyholders, although it could also be used for operating purposes if required. The passage of the National Affordable Housing Act in November 1990 effectively suspended the issuance of distributive shares from the MMI Fund until the Fund meets certain equity requirements.

Under the National Affordable Housing Act, the MMI Fund must attain a capital ratio of 2.0% within 10 years of enactment. The Act defines the capital ratio as the ratio of the economic net worth of the Fund to unamortized insurance in force. Unamortized insurance in force is defined by the Act to be the remaining obligation on outstanding mortgages. Thus, "unamortized insurance in force" as defined by the Act is the same as the MMI Fund's insurance in force disclosed in Note 11. The economic net worth, as defined by the Act, is the current cash available to the Fund, plus the present value of all future cash inflows and outflows expected to result from the outstanding mortgages insured by the Fund. Since fiscal year 1989, FHA has performed ongoing studies of the actuarial soundness of the MMI Fund. These studies may be used, in part, to estimate the economic net worth of the MMI Fund. The results of the most recent study indicate that the MMI Fund has an economic value of approximately $4,554 million and a capital ratio of 1.44% as of September 30, 1993. The MMI Fund's economic net worth differs from the Fund's equity determined in accordance with generally accepted accounting principles (GAAP) because GAAP-determined equity is not based on the net present value of future cash flows.

Capital has not yet been appropriated to cover all cumulative losses for the GI and SRI Funds determined in accordance with GAAP even though the National Housing Act and the Federal Credit Reform Act authorize appropriations to finance these losses. As discussed in Note 10, credit reform-related appropriations will become available to finance these losses to the extent financing from other sources is insufficient to do so.

### Note 10. Credit Appropriations

FHA's activities are subject to the Federal Credit Reform Act of 1990 ("Credit Reform"), which became effective on October 1, 1991. A primary purpose of Credit Reform is to more accurately measure the "subsidy" cost of Federal credit programs.

Subsidy costs generally comprise the present value of estimated costs associated with loan defaults and interest rate subsidies, net of the present value of estimated collections for insurance premiums and claim recoveries.

For loans insured on or after October 1, 1991, up-front appropriations are required to finance credit subsidy costs. This requirement has had a significant effect on FHA, particularly the GI Fund, and to a lesser degree the SRI Fund. Appropriations to finance subsidy costs in the GI/SRI Funds were $124 million and $86 million in fiscal year 1993 and fiscal year 1992, respectively.

FHA's MMI Fund has not required a subsidy appropriation for insurance endorsed post October 1, 1991 because premiums charged for these books of business are estimated to exceed associated costs. The FHA MMI Fund also must achieve a statutory capital ratio that, in effect, requires capital reserves as a cushion against future defaults.

For loans insured prior to October 1, 1991, the effective date of Credit Reform, permanent indefinite appropriations are available to finance costs associated with such loans to the extent premiums, recoveries and financing are insufficient to do so. Appropriations for pre-Credit Reform loans amounted to $500 million in 1993 and $1,207 million in 1992.

At the end of fiscal year 1993, FHA reduced its credit appropriation balance by $34 million as a result of its annual budget re-estimation process. Such re-estimates are required by Credit Reform to update and adjust for new information as the loan matures.

FHA also receives appropriations to finance credit-related administrative expenses. These appropriations cover expenses for all loans regardless of the year in which the credits were originated (i.e., both pre- and post-Credit Reform loans). These annual appropriations are separate from subsidy appropriations, and are not determined on a present value basis.

For the GI/SRI Funds, appropriations for administrative costs were $187 million and $189 million in 1993 and 1992, respectively. For the MMI Fund, administrative costs of $256 million in both 1993 and 1992 were covered by premiums received by the program.

Through September 30, 1993, appropriations received for the cost of both pre- and post-Credit Reform insured loans have been accounted for in accordance with Generally Accepted Accounting Principles (GAAP). Under GAAP, appropriated capital received pursuant to Credit Reform is the balance available to fund future expenses. However, the accounting treatment for loans insured on or after October 1, 1991, may change in fiscal year 1994 pursuant to an accounting standard published by the Office of Management and Budget after recommendation by the Federal Accounting Standards Advisory Board, and approval by OMB, Treasury, and the General Accounting Office. The effect this change may have on FHA's financial statements has yet to be determined.

## Note 11. Insurance in Force/Off Balance Sheet Risk

Insurance in force, which constitutes off balance sheet risk, is the original insured balance of all cases still in force, less principal payments made on the mortgages to date. Insurance in force outstanding as of September 30, 1993, was as follows (dollars in millions):

| Fund | Single Family | Multifamily | Title I | Total |
|---|---|---|---|---|
| MMI | $ 285,487 | $ 0 | $ 0 | $285,487 |
| CMHI | 0 | 363 | 0 | 363 |
| GI | 23,402 | 36,617 | 5,360 | 65,379 |
| SRI | 3,653 | 6,912 | 0 | 10,565 |
| Total | $ 312,542 | $ 43,892 | $ 5,360 | $361,794 |

Insurance in force outstanding as of September 30, 1992, was as follows (dollars in millions):

| Fund | Single Family | Multifamily | Title I | Total |
|---|---|---|---|---|
| MMI | $ 301,730 | $ 0 | $ 0 | $301,730 |
| CMHI | 0 | 395 | 0 | 395 |
| GI | 23,500 | 35,887 | 5,518 | 64,905 |
| SRI | 4,284 | 7,274 | 0 | 11,558 |
| Total | $ 329,514 | $ 43,556 | $ 5,518 | $378,588 |

Insurance written, by Fund, during 1993 and 1992 was: $60.2 billion and $42.1 billion, respectively, for the MMI Fund; $9.6 billion and $7.6 billion, respectively, for the GI Fund; and $90 million and $164 million, respectively, for the SRI Fund.

FHA's insurance is for losses that result when borrowers default on their mortgage payments. FHA mortgage insurance covers only default risk, and thus FHA is not exposed to losses resulting from interest rate fluctuations, except in the case of mortgages insured pursuant to Section 221(g)(4) of the National Housing Act, as discussed in Note 12. In most cases, FHA insures 100% of the mortgage principal. However, when FHA pays claims resulting from mortgage defaults, it is normally able to recover a portion of the claim through the foreclosure and subsequent sale of the mortgaged property.

FHA's MMI Fund provides mortgage insurance principally for 30-year fixed rate home mortgages. By law the MMI Fund must be operated in accordance with "sound actuarial and accounting practice," and thus borrowers should be charged a premium that will cover default losses and administrative expenses, and provide equity. Like all FHA activities, the MMI Fund suffers losses when premium income is insufficient to cover default losses and administrative costs. The magnitude of these losses is greater when there is either an increase in the number of mortgage defaults or a decrease in amounts recovered from the sale of foreclosed properties. The fact that the MMI Fund primarily insures low downpayment mortgages makes it more susceptible to losses resulting from economic downturns. Such downturns can both increase the number of defaults and cause lower claim recoveries when foreclosed properties are sold. Either situation could result in the MMI Fund experiencing greater losses.

The GI Fund provides mortgage insurance for loans involving cooperatives, condominiums, nursing homes, hospitals, and for low and moderate income multifamily loans involving construction, rehabilitation and refinancing. While the GI Fund's insurance in force is much less than that of the MMI Fund, its exposure to loss may be much greater. Unlike the MMI Fund, the GI Fund has no statutory requirement to be sound. In carrying out its mission, FHA's GI Fund assumes levels of default risk not generally borne by commercial insurers or lenders. Furthermore, the GI Fund is susceptible to losses resulting from weaknesses in commercial and residential real estate markets at both the regional and national levels. Aggregate premiums charged by the GI Fund have not been sufficient to cover default losses and administrative costs or to build equity. As a result, the GI Fund is dependent on appropriations to sustain its operations.

Activity for FHA's other two funds, SRI and CMHI, has been substantially curtailed in recent years. Most of the programs in the SRI and CMHI Funds have very little activity. As a result, FHA's exposure to additional loss from these two funds is comparatively small.

The significant concentrations of FHA's Multifamily insurance risk by insurance program, and the percent that the program is to the total Multifamily insurance in force, are as follows (dollars in billions):

| Program | IIF | Percent |
|---|---|---|
| Section 221(d)(4) - Market Rate | $16.2 | 36.9% |
| Section 207 - Rental Housing | 6.9 | 15.7% |
| Section 236 - Interest Subsidy | 5.5 | 12.5% |
| Section 242 - Hospital | 4.4 | 10.0% |

Except for the Hospital Program, the concentration of risk is geographically disbursed. The insurance in force for the hospital program is located primarily in the Northeast, with 95% of the $4.4 billion unpaid principal balance of the insurance in force attributed to this region. New York state constitutes over 80% of the insurance in force for hospitals. The highest geographic concentration of risk for the other multifamily programs is in New York (12%) and California (10%) -- no other state or region comprises more than 5% of the unpaid principal balance.

## Note 12. Commitments and Contingencies

### Section 221(g)(4) Program Contingent Liability

Prior to the passage of the National Affordable Housing Act (the Act), single family and multifamily mortgages insured under Section 221 of the National Housing Act that were neither delinquent nor in default could have been assigned to FHA pursuant to Section 221(g)(4) by lenders in exchange for FHA debentures bearing current interest rates. Eligible mortgagees could elect to assign their current mortgages to FHA during the year following the 20th anniversary after final endorsement of the mortgage. The assignment of these mortgages resulted in an additional cost to FHA to the extent that Treasury-established debenture rates exceeded the mortgage interest rates.

However, under the National Affordable Housing Act, FHA must now arrange for the sale of the beneficial interest in the multifamily mortgage in lieu of accepting assignment after the 20th anniversary. The sales price to be paid to the lender must be at par (in effect, the outstanding principal balance at the time of the sale under the original mortgage terms) plus accrued interest. To ensure a par value price is realized, the Act authorizes FHA to make subsidy payments. Subsidy payments to be made from the GI Fund will result when market interest rates exceed the interest rate on the affected mortgages. While FHA's GI Fund may still bear additional costs to the extent market interest rates exceed the interest rates on the mortgages, the Act's provisions will curtail the number of multifamily mortgages that will be assigned to FHA. In effect, this will reduce some of FHA's future administrative burden since FHA will not have to service loans that otherwise would have been assigned to it. Provisions for single family mortgages insured pursuant to Section 221 remain unchanged.

The Act provides for continued auctions of the 221(g)(4) multifamily mortgages through 1995. Management has estimated that, depending on future interest rates, approximately 800 mortgages with an unpaid principal balance of $940 million could elect assignment through 1995. The present value of future subsidy payments to be made by FHA could be $80 million depending on the number of mortgages assigned and the future interest rates. In addition, while the Act only provides for the sale of mortgages assigned through 1995, additional multifamily mortgages could be eligible for sale if Congress extends the requirement for the sale of 221(g)(4) mortgages beyond 1995. Management has estimated that up to 3,500 mortgages with an unpaid principal balance of $7,800 million could be assigned after 1995, depending on future interest rates. The present value of future subsidy payments on these mortgages could approximate $420 million.

The estimates above are dependent upon predictions of future interest rates. The difficulty of predicting future interest rates creates a potential for large deviations in these estimates. Therefore, the contingent liability for subsequent subsidy payments, if any, resulting from the Section 221(g)(4) assignment sale program has not yet been recorded in the Consolidated Statement of Financial Position.

### Lawsuits and Other

FHA is party in various legal actions and claims brought by or against it. In the opinion of management and general counsel, the ultimate resolution of these legal actions and claims will not materially affect FHA's financial position or results of operations as of and for the fiscal year ended September 30, 1993.

## Note 13. Reconciliation of Budgetary Resources and Actual Expenses

The following schedule reconciles total expenses in the consolidated statement of operations to accrued expenditures as reported under budgetary requirements to the U.S. Treasury at September 30 (dollars in millions):

| Program Name | Budget | | | | Actual | |
|---|---|---|---|---|---|---|
| | 1993 | | 1992 | | 1993 | 1992 |
| | Resources | Obligations | Resources | Obligations | | |
| MMI/CMHI Liquidating | $ 9,983 | $ 4,928 | $ 10,334 | $ 4,999 | $ 1,694 | $ 1,353 |
| MMI/CMHI Financing | 2,566 | 1,865 | 1,296 | 761 | 12 | 0 |
| MMI/CMHI Program | 256 | 256 | 256 | 256 | 256 | 256 |
| GI/SRI Liquidating | 2,414 | 1,806 | 2,795 | 2,404 | (1,123) | 7,616 |
| GI/SRI Financing | 307 | 46 | 62 | 0 | 6 | 0 |
| GI/SRI Program | 357 | 340 | 274 | 228 | 187 | 189 |
| Total | $ 15,883 | $ 9,241 | $ 15,017 | $ 8,648 | $ 1,032 | $ 9,414 |

| | 1993 | 1992 |
|---|---|---|
| Total Expenses | $ 1,032 | $ 9,414 |
| Add: | | |
| Claims Settlement Payments | 6,210 | 6,818 |
| Less: | | |
| (Decrease) Increase In Loss Reserves | (1,784) | 6,558 |
| Provision For Losses on Foreclosed Properties | 1,981 | 1,299 |
| Provision For Losses on Mortgage Notes Held | 164 | 914 |
| Increase (Decrease) In Payables and Other Liabilities | (45) | (89) |
| Increase (Decrease) In Other Assets | (39) | (52) |
| Administrative Expenses Funded From Negative Subsidy | (256) | (256) |
| Subtotal | 21 | 8,374 |
| Accrued Expenditures | 7,221 | 7,858 |
| Less Reimbursements | 7,340 | 7,512 |
| Accrued Expenditures, Direct | $ (119) | $ 346 |

For the FHA Funds, obligations are not separated into direct obligations and reimbursed obligations. Appropriations received were: subsidy appropriations of $124 million and $85 million for the GI/SRI Program account in fiscal year 1993 and 1992, respectively; permanent indefinite appropriations of $500 million and $1,207 million for the GI/SRI Liquidating account in fiscal year 1993 and 1992, respectively; administrative expense appropriations of $187 million and $189 million for the GI/SRI Program account in fiscal year 1993 and 1992, respectively; and, administrative expenses of $256 million and $256 million for the MMI/CMHI Program account in fiscal year 1993 and 1992, respectively, which were covered by premiums received by the program account.

FEDERAL HOUSING ADMINISTRATION
(AN AGENCY OF THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT)
CONSOLIDATING STATEMENT OF FINANCIAL POSITION
SEPTEMBER 30, 1993 AND 1992
(Dollars in Millions)

| | MMI | | CMHI | | GI | | SRI | | CONSOLIDATED | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 1993 | 1992 | 1993 | 1992 | 1993 | 1992 | 1993 | 1992 | 1993 | 1992 |
| ASSETS: | | | | | | | | | | |
| Fund Balances at the U.S. Treasury: | | | | | | | | | | |
| Non-Interest-bearing | $ 536 | $ 58 | $ 7 | $ 14 | $ 109 | $ 83 | $ 182 | $ 114 | $ 834 | $ 269 |
| Interest-bearing | 706 | 700 | 0 | 0 | 212 | 40 | 3 | 1 | 921 | 741 |
| Total Fund Balances at the U.S. Treasury | 1,242 | 758 | 7 | 14 | 321 | 123 | 185 | 115 | 1,755 | 1,010 |
| Investments in U.S. Government Securities | 5,140 | 5,781 | 15 | 8 | 0 | 0 | 0 | 0 | 5,155 | 5,789 |
| Foreclosed Property Held for Sale, Net | 1,281 | 1,270 | 0 | 0 | 285 | 213 | 26 | 32 | 1,592 | 1,515 |
| Mortgage Notes Receivable, Net | 2,639 | 2,275 | 1 | 1 | 2,615 | 2,470 | 606 | 608 | 5,861 | 5,354 |
| Other Assets and Receivables | 274 | 254 | 0 | 0 | 180 | 163 | 46 | 44 | 500 | 461 |
| Total Assets | $ 10,576 | $ 10,338 | $ 23 | $ 23 | $ 3,401 | $ 2,969 | $ 863 | $ 799 | $ 14,863 | $ 14,129 |
| LIABILITIES AND GOVERNMENT EQUITY: | | | | | | | | | | |
| Claims Payable | $ 410 | $ 393 | $ 0 | $ 0 | $ 258 | $ 362 | $ 10 | $ 7 | $ 678 | $ 762 |
| Loss Reserves | 2,171 | 2,215 | 6 | 0 | 8,697 | 10,581 | 2,005 | 1,867 | 12,879 | 14,663 |
| Unearned Premiums | 6,352 | 6,125 | 1 | 1 | 112 | 92 | 17 | 17 | 6,482 | 6,235 |
| Debentures Issued to Claimants | 0 | 0 | 1 | 1 | 212 | 299 | 0 | 1 | 213 | 301 |
| Accounts Payable, Accrued Expenses and Other Liabilities | 163 | 140 | 0 | 0 | 382 | 368 | 52 | 50 | 597 | 558 |
| Distributive Shares and Premium Refunds Payable | 305 | 302 | 0 | 0 | 0 | 0 | 0 | 0 | 305 | 302 |
| Elimination of Interfund Balances | 0 | 0 | 0 | 0 | (20) | (20) | 20 | 20 | 0 | 0 |
| Total Liabilities | $ 9,401 | $ 9,175 | $ 8 | $ 2 | $ 9,641 | $ 11,682 | $ 2,104 | $ 1,962 | $ 21,154 | $ 22,821 |
| Government Equity (Deficiency): | | | | | | | | | | |
| Mutual Funds Equity | 1,156 | 1,144 | 15 | 21 | 0 | 0 | 0 | 0 | 1,171 | 1,165 |
| Subsidized Funds Cumulative Losses | 0 | 0 | 0 | 0 | (17,279) | (18,976) | (5,363) | (5,284) | (22,642) | (24,260) |
| Appropriated Capital | 19 | 19 | 0 | 0 | 11,039 | 10,263 | 4,122 | 4,121 | 15,180 | 14,403 |
| Total Government Equity (Deficiency) | 1,175 | 1,163 | 15 | 21 | (6,240) | (8,713) | (1,241) | (1,163) | (6,291) | (8,692) |
| Total Liabilities and Government Equity | $ 10,576 | $ 10,338 | $ 23 | $ 23 | $ 3,401 | $ 2,969 | $ 863 | $ 799 | $ 14,863 | $ 14,129 |

FEDERAL HOUSING ADMINISTRATION
(AN AGENCY OF THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT)
CONSOLIDATING STATEMENT OF OPERATIONS AND GOVERNMENT EQUITY (DEFICIENCY)
FOR THE YEARS ENDED SEPTEMBER 30, 1993 AND 1992
(Dollars in Millions)

| | MMI | | CMHI | | GI | | SRI | | CONSOLIDATED | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 1993 | 1992 | 1993 | 1992 | 1993 | 1992 | 1993 | 1992 | 1993 | 1992 |
| REVENUES | | | | | | | | | | |
| Premiums: | | | | | | | | | | |
| Annual Premiums | $ 445 | $ 289 | $ 0 | $ 0 | $ 106 | $ 98 | $ 21 | $ 24 | $ 572 | $ 411 |
| Earned Portion of Up-front Premiums | 820 | 911 | 2 | 2 | 216 | 224 | 37 | 36 | 1,075 | 1,173 |
| Total Premiums Earned | 1,265 | 1,200 | 2 | 2 | 322 | 322 | 58 | 60 | 1,647 | 1,584 |
| Interest Income | 622 | 653 | 0 | 1 | 132 | 116 | 57 | 57 | 811 | 827 |
| Other Revenues | 81 | 48 | 0 | 0 | 111 | 116 | 8 | 14 | 200 | 178 |
| Total Revenues | 1,968 | 1,901 | 2 | 3 | 565 | 554 | 123 | 131 | 2,658 | 2,589 |
| EXPENSES | | | | | | | | | | |
| (Decrease) Increase in Loss Reserves | (44) | 76 | 6 | 0 | (1,884) | 4,771 | 138 | 1,711 | (1,784) | 6,558 |
| Provision for Losses on Properties Owned | 1,457 | 1,101 | 0 | 0 | 468 | 188 | 56 | 10 | 1,981 | 1,299 |
| Provision for Losses on Mortgage Notes Held | 203 | 132 | 0 | 0 | (21) | 687 | (18) | 95 | 164 | 914 |
| Salary and Administrative Expenses | 302 | 283 | 0 | 0 | 210 | 214 | 2 | 4 | 514 | 501 |
| Other Expense | 38 | 17 | 0 | 0 | 95 | 119 | 24 | 6 | 157 | 142 |
| Total Expenses | 1,956 | 1,609 | 6 | 0 | (1,132) | 5,979 | 202 | 1,826 | 1,032 | 9,414 |
| Excess (Deficiency) of Revenues over Expenses | 12 | 292 | (4) | 3 | 1,697 | (5,425) | (79) | (1,695) | 1,626 | (6,825) |
| Government Equity (Deficiency), Beginning of Year | 1,163 | 871 | 21 | 20 | (8,713) | (4,769) | (1,163) | 531 | (8,692) | (3,347) |
| Appropriations | 0 | 0 | 0 | 0 | 776 | 1,481 | 1 | 1 | 777 | 1,482 |
| Distributive Shares Paid | 0 | 0 | (2) | (2) | 0 | 0 | 0 | 0 | (2) | (2) |
| Government Equity (Deficiency), End of Year | $ 1,175 | $ 1,163 | $ 15 | $ 21 | $ (6,240) | $ (8,713) | $ (1,241) | $ (1,163) | $ (6,291) | $ (8,692) |

FEDERAL HOUSING ADMINISTRATION
(AN AGENCY OF THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT)
CONSOLIDATING STATEMENT OF GOVERNMENT EQUITY (DEFICIENCY)
FOR THE YEARS ENDED SEPTEMBER 30, 1993 AND 1992
(Dollars in Millions)

| | Mutual Funds Equity | | | Subsidized Funds Cumulative Losses | | | Appropriated Capital | | | | Equity |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | MMI | CMHI | Total | GI | SRI | Total | MMI | GI | SRI | Total | Total |
| Balance at September 30, 1991 | $ 852 | $ 20 | $ 872 | $ (13,551) | $ (3,589) | $ (17,140) | $ 19 | $ 8,782 | $ 4,120 | $ 12,921 | $ (3,347) |
| (Deficiency) Excess of Revenue over Expenses | 292 | 3 | 295 | (5,425) | (1,695) | (7,120) | 0 | 0 | 0 | 0 | (6,825) |
| Distributive Shares Paid | 0 | (2) | (2) | 0 | 0 | 0 | 0 | 0 | 0 | 0 | (2) |
| Credit Appropriations Received and Obligated to Finance: | | | | | | | | | | | |
| Credit Subsidies on insured 1992 mortgages | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 85 | 1 | 86 | 86 |
| Administrative Expenses | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 189 | 0 | 189 | 189 |
| Losses on Loans insured Prior to Sept 30, 1991 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 1,207 | 0 | 1,207 | 1,207 |
| Balance at September 30, 1992 | 1,144 | 21 | 1,165 | (18,976) | (5,284) | (24,260) | 19 | 10,263 | 4,121 | 14,403 | (8,692) |
| (Deficiency) Excess of Revenue over Expenses | 12 | (4) | 8 | 1,697 | (79) | 1,618 | 0 | 0 | 0 | 0 | 1,626 |
| Distributive Shares Paid | 0 | (2) | (2) | 0 | 0 | 0 | 0 | 0 | 0 | 0 | (2) |
| Credit Appropriations Received and Obligated to Finance: | | | | | | | | | | | |
| Credit Subsidies on Insured 1992 mortgages | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 123 | 1 | 124 | 124 |
| Administrative Expenses | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 187 | 0 | 187 | 187 |
| Losses on Loans insured Prior to Sept 30, 1991 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 500 | 0 | 500 | 500 |
| 1992 Credit Subsidy returned to Treasury as a result of re-estimate | 0 | 0 | 0 | 0 | 0 | 0 | 0 | (34) | 0 | (34) | (34) |
| Balance at September 30, 1993 | $ 1,156 | $ 15 | $ 1,171 | $ (17,279) | $ (5,363) | $ (22,642) | $ 19 | $ 11,039 | $ 4,122 | $ 15,180 | $ (6,291) |

## Consolidating Statement of Cash Flows

FEDERAL HOUSING ADMINISTRATION
(AN AGENCY OF THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT)
CONSOLIDATING STATEMENT OF CASH FLOWS
FOR THE YEARS ENDED SEPTEMBER 30, 1993 AND 1992
(Dollars in Millions)

| | MMI | | CMHI | | GI | | SRI | | CONSOLIDATED | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 1993 | 1992 | 1993 | 1992 | 1993 | 1992 | 1993 | 1992 | 1993 | 1992 |
| **Cash Flows from Operating Activities** | | | | | | | | | | |
| Excess (Deficiency) of Revenues over Expenses | $ 12 | $ 292 | $ (4) | $ 3 | $ 1,697 | $ (5,425) | $ (79) | $ (1,695) | $ 1,626 | $ (6,825) |
| Adjustments to Reconcile Excess (Deficiency) to Cash Provided (Used) by Operating Activities: | | | | | | | | | | |
| (Decrease) Increase in Loss Reserves | (44) | 76 | 6 | 0 | (1,884) | 4,771 | 138 | 1,711 | (1,784) | 6,558 |
| Up-front Premiums Collected | 2,258 | 1,524 | 2 | 2 | 244 | 222 | 37 | 37 | 2,541 | 1,785 |
| Up-front Premiums Refunded | (1,211) | (422) | 0 | 0 | (8) | (11) | 0 | 0 | (1,219) | (433) |
| Up-front Premiums Earned | (820) | (911) | (2) | (2) | (216) | (224) | (37) | (36) | (1,075) | (1,173) |
| Claims Settlement Payments | (4,782) | (4,831) | 0 | 0 | (1,345) | (1,867) | (83) | (120) | (6,210) | (6,818) |
| Collections of Principal on Notes Acquired in Claims Settlement | 141 | 51 | 0 | 0 | 742 | 344 | 32 | 52 | 915 | 447 |
| Proceeds from Disposition of Assets Acquired in Claims Settlement | 2,700 | 2,721 | 0 | 0 | 374 | 191 | 90 | 34 | 3,164 | 2,946 |
| Increase (Decrease) in Loss Allowances on Properties and Mortgages | 1,660 | 1,233 | 0 | 0 | 447 | 875 | 38 | 105 | 2,145 | 2,213 |
| (Increase) Decrease in Other Assets | (20) | 7 | 0 | 0 | (17) | (54) | (2) | (5) | (39) | (52) |
| Increase in Claims Payable and Other Liabilities | 43 | 126 | 0 | 0 | (90) | (219) | 5 | 4 | (42) | (89) |
| Other, net | (100) | (9) | 0 | 0 | (435) | (23) | (69) | (4) | (604) | (36) |
| **Net Cash Provided (Used) by Operations** | (163) | (143) | 2 | 3 | (491) | (1,420) | 70 | 83 | (582) | (1,477) |
| **Cash Flows from Investing Activities:** | | | | | | | | | | |
| Increase in Deposit U.S. Treasury Interest-Bearing Account | (6) | (700) | 0 | 0 | (172) | (40) | (2) | (1) | (180) | (741) |
| Purchase of Investment Securities | (2,303) | (396) | (10) | 0 | 0 | 0 | 0 | 0 | (2,313) | (396) |
| Proceeds from Redemptions of Investment Securities | 2,950 | 1,180 | 3 | 11 | 0 | 0 | 0 | 0 | 2,953 | 1,191 |
| Other, Net | 0 | 3 | 0 | 0 | 0 | 3 | 0 | 1 | 0 | 7 |
| **Net Cash (Used) Provided by Investing Activities** | 641 | 87 | (7) | 11 | (172) | (37) | (2) | 0 | 460 | 61 |
| **Cash Flows from Financing Activities:** | | | | | | | | | | |
| Appropriations Received | 0 | 0 | 0 | 0 | 776 | 1,481 | 1 | 1 | 777 | 1,482 |
| Issuance of Debentures to Claimants | 0 | 0 | 0 | 0 | 275 | 322 | 0 | 2 | 275 | 324 |
| Payment of Debentures | 0 | 0 | 0 | 0 | (362) | (351) | (1) | (8) | (363) | (359) |
| Distributive Shares Paid | 0 | 0 | (2) | (2) | 0 | 0 | 0 | 0 | (2) | (2) |
| **Net Cash (Used) Provided by Financing Activities** | 0 | 0 | (2) | (2) | 689 | 1,452 | 0 | (5) | 687 | 1,445 |
| Net Increase (Decrease) in Cash-Non-Interest-Bearing | 478 | (56) | (7) | 12 | 26 | (5) | 68 | 78 | 565 | 29 |
| Cash - Non-Interest-Bearing, Beginning of Year | 58 | 114 | 14 | 2 | 83 | 88 | 114 | 36 | 269 | 240 |
| Cash - Non-Interest-Bearing, End of Year | $ 536 | $ 58 | $ 7 | $ 14 | $ 109 | $ 83 | $ 182 | $ 114 | $ 834 | $ 269 |

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